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The great telecoms crash

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Politics this week

Jul 18th 2002
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Clash in Kashmir

AP

At least 28 Hindus were killed and 13 injured in two separate attacks in Indian-controlled **Kashmir**. Muslim rebels are being held responsible, renewing Indian calls for the dismantling of Pakistan-based militant training camps.

See article: India, Pakistan and Kashmir

A Pakistani anti-terrorism court sentenced Ahmad Omar Saeed Sheikh, a British-born Islamic militant, to death for the kidnap and murder of **Daniel Pearl**, a *Wall Street Journal* reporter. Prosecutors are seeking the death penalty for three others found guilty of involvement in the murder.

Two American Marine helicopters collided on the runway of a **Singapore** military base, killing a technician. The city-state hosts a United States navy centre.

President Kim Dae Jung appointed South Korea's first **female prime minister**, Chang Sang, who was educated at Princeton. Six new ministers were also named in a reshuffle aimed at boosting the government's popularity before December's presidential election.

Diplomatic immunity

The United Nations Security Council unanimously passed a resolution extending temporary immunity from the **International Criminal Court's** jurisdiction to America's UN peacekeepers, thus ending a lengthy row between America and its allies over the newly established court.

See article: The row over the International Criminal Court

John Walker Lindh did a deal with the American government: in exchange for various charges being dropped, the “American Taliban” will co-operate with the government, and will serve two consecutive ten-year sentences in a prison close to his family.

See article: No trial for John Walker Lindh

The **FBI**'s chief of counter-terrorism, Dale Watson, said that he thought that Osama bin Laden was dead. An Arab newspaper in London said that it thought the terrorist leader was in good health.

AP

Six alternative plans to replace the **World Trade Centre** were unveiled in New York. All involve clusters of smaller buildings. A design should be chosen by the end of this year.

See article: Rebuilding New York city

Disunited front

The **Middle Eastern quartet**—America, Russia, the European Union and the UN—met to draft a common approach but quickly fell out over America's insistence that the priority was to remove Yasser Arafat as the Palestinians' leader.

See article: Middle East endgame

Two **suicide bombers** from Islamic Jihad killed three Israelis in Tel Aviv, the first such attack for a month. Earlier, three Palestinian gunmen, disguised as Israeli soldiers, ambushed a bus close to an Israeli settlement in the West Bank, killing eight people. Three Palestinian groups claimed responsibility.

See article: The killings begin again

The Economist's correspondent in **Zimbabwe**, Andrew Meldrum, was acquitted of publishing a falsehood but immediately ordered to leave the country. He won leave to appeal to the Supreme Court.

See article: Zimbabwe orders our correspondent out

Zambia's parliament voted to revoke ex-President Frederick Chiluba's immunity from prosecution in order to investigate allegations of massive corruption. A judge ordered a halt to the investigation pending a ruling as to whether parliament had acted legally.

See article: Zambian politics

Mosiuoa Lekota, **South Africa's** defence minister, angrily denied a newspaper report that 60% of South African soldiers were HIV positive. He said the true figure was 23%.

Bye-bye Bulent

Turkey's embattled prime minister, Bulent Ecevit, whose three-party coalition has been disintegrating, said he would bow out. A general election is likely in the autumn.

See article: Turkey's political and economic woes

France's president, **Jacques Chirac,** survived an assassination attempt by an extreme right-wing student.

See article: France's president has a new lease of life

Croatia was briefly in turmoil when its reform-minded prime minister, Ivica Racan, resigned after Drazen Budisa, his main rival in the ruling five-party coalition, deserted it. But Mr Racan seems likely to cobble together a new governing alliance.

The chairman of **Albania's** ruling (ex-communist) Socialists, Fatos Nano, who heads the party's old-guard faction, looked set to become prime minister again in place of Pandeli Majko, a moderniser only four months into the job.

Spain recaptured the tiny island of Perejil, off the coast of Morocco, four days after Moroccan troops landed on it and put up their national flag. Spain's new foreign minister, Ana Palacio, said her country was acting in self-defence. Morocco asked Arab and Muslim countries for help.

AP

See article: Spain and Morocco, nose to nose

The **IRA** unexpectedly issued a statement apologising for the death of hundreds of “non-combatants” during its terror campaign of over 30 years in Northern Ireland. The British and Irish governments guardedly welcomed the move; the province's unionists were openly scathing.

See article: The IRA's apology

Greek police said they had nabbed a 60-year-old man suspected of being a leader of November 17, a left-wing terrorist group which had killed 23 people since 1975 without any culprit having been caught, until another suspected member accidentally blew himself up last month.

Germany's defence minister, Rudolf Scharping, was sacked over a payments row and replaced by Peter Struck, the ruling Social Democrats' parliamentary floor leader.

Neutral **Switzerland** formally applied to join the UN.

Toledo courts popularity

AP

In an attempt to shore up support for his unpopular government before regional elections in November, **Peru's** president, Alejandro Toledo, sacked his market-friendly prime minister and finance minister.

See article: Peru's reshuffled government

Paraguay's president, Luis Gonzalez Macchi, briefly imposed a state of emergency, following anti-government protests in which two people were killed and dozens more injured.

See article: Paraguay's state of emergency

Ciro Gomes, a soft-left former state governor, surged into contention in **Brazil's** presidential election campaign. An opinion poll put him firmly in second place, behind Luiz Inacio Lula da Silva, the left-wing front-runner, but seven points ahead of Jose Serra, the government candidate.

El Niño weather struck the Andes: 59 people died in a freak cold snap in southern Peru, while 60 were feared dead in a landslide in Ecuador.

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Business this week

Jul 18th 2002
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Auf wiedersehen, Ron

Ron Sommer's seven-year tenure as chief executive of **Deutsche Telekom** ended with his resignation. Pressure to quit had come from the company's biggest shareholder, the German government. Mr Sommer presided over a 90% fall in DT's share price over the past two years.

See article: Deutsch Telekom

AT&T picked its president, David Dorman, to succeed Michael Armstrong as chairman and chief executive. Mr Dorman promptly declared that WorldCom's demise had increased the likelihood of telecoms mergers. Separately, Michael Powell, the federal telecoms regulator, hinted that he might let a local “Baby Bell” buy WorldCom.

See article: The telecoms crisis

Pfizer, the world's biggest drug company, stiffened its position at the top. It swallowed up **Pharmacia**, a fellow American drug firm, for shares worth some $60 billion. Pharmacia's shares shot up by 20%. Pfizer's investors were unconvinced; its shares fell by 10%.

See article: Pfizer buys Pharmacia

Stephan Rietiker was sacked as chief executive of **Centerpulse**, a Swiss maker of medical devices, after less than a year in charge. Mr Rietiker put the company back on its feet after a product-liability suit in America over the supply of faulty artificial joints but then fell out with senior managers.

Motoring ahead

General Motors saw profits leap in the second quarter to $1.3 billion, up from $477m a year ago. Cost-cutting and generous financing packages in America helped the car giant, but its European operations languished. It gave warning of a heavy writedown in the next quarter for its stake in Italy's Fiat.

Ford returned to the black in the second quarter, after losses totalling $5.5 billion last year. The world's number two car maker made profits of $570m.

Draconian cost-cutting at **Merrill Lynch**—nearly 20% of its staff have been jettisoned since the start of last year—paid off. Profits at the bank rose by 17% in the second quarter compared with a year ago, to $634m. This is despite a $100m fine paid to settle charges that it misled investors by talking up hapless dotcom firms.

Citigroup, the American financial-services giant, also announced surprisingly strong profits, up by 15% to $4.1 billion for the quarter. **J.P. MorganChase** added to Wall Street's good cheer with a near trebling of profits to $1 billion.

America's stockmarkets responded to these announcements by picking up a little after a bad week. The Dow Jones Industrial Average recovered from ten-month lows; the S&P 500 also bounced, after reaching its lowest point since August 1997.

See article: Stockmarkets

Air loss

AMR, parent company of American Airlines, reported a loss of $495m in the second quarter after similar losses in the first quarter. There was little optimism for the next three months despite heavy cuts in both capacity and costs.

The parlous state of the world microchip market cost the jobs of 4,000 **Intel** employees, some 5% of the workforce.

IBM reported second-quarter profits of $56m, down by 97%, after the company took a charge of $1.4 billion for job cuts and getting out of loss-making businesses.

The real thing

Restoring some faith in American capitalism was left to **Coca-Cola**. It promised to start charging the cost of stock options against profits later this year, so as to make its accounts more transparent. The impact on Coke's profits is expected to be minimal.

See article: Corporate reform in America

After George Bush's promise to crack down on **corporate wrongdoing** the Senate passed a bill to improve boardroom accountability. The bill includes stronger penalties, including jail terms, for fraud. But an attempt to make companies account for stock options as an expense failed.

See article: Congress gets tough

The International Accounting Standards Board, a private body responsible for devising international standards, drew up new rules that would require **stock options** to be treated as expenses beginning in 2004. The EU may require European companies to comply, but only by 2007.

Trichet's tribulations

Jean-Claude Trichet's ambition to become president of the **European Central Bank** was dented after a French magistrate unexpectedly ordered that he stand trial in connection with a banking scandal at Crédit Lyonnais in the early 1990s. France regards the ECB job as rightfully its own but it may have to find another candidate or even accept a well-qualified foreigner (but never a German).

See article: The succession at the European Central Bank

Mr Trichet's woes do not appear to have done the **euro** any harm, at least. It achieved parity with the dollar for the first time since February 2000. America's currency also hit a 17-month low against the yen.

See article: The dollar

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Telecoms

The great telecoms crash

Jul 18th 2002
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Behind the general jitters in stockmarkets lies the biggest and fastest rise and fall in business history

"TODAY, there is no economy but the global economy, no Internet but the global Internet, and no network but the global network," wrote George Gilder, a technology guru, in February 2001. He predicted that two telecoms firms, Global Crossing and 360networks, "will battle for worldwide supremacy, but in a trillion-dollar market, there will be no loser." Yet within a year, both had filed for bankruptcy—a graphic illustration of how quickly the industry's titans have been toppled. There were losers after all: banks and shareholders, who are now smarting from enormous debt write-offs and precipitous declines in telecoms share prices.

The past few weeks have seen general falls in stockmarkets in America and all round the world, in many cases to six-year lows. These have been interspersed with ineffective efforts by President George Bush to reassure investors that economic fundamentals are sound and that corporate America is in better shape than recent scandals might suggest. There is good reason to worry about a new recession, and not only in the United States, yet for the moment the data do not support this concern. Where the pain can readily be seen is in the industry at the heart of the corporate malfeasance: telecoms.

The telecoms bust is some ten times bigger than the better-known dotcom crash: the rise and fall of telecoms may indeed qualify as the largest bubble in history. Telecoms firms have run up total debts of around $1 trillion. And as if this were not enough, the industry has also disgraced itself by using fraudulent accounting tricks in an attempt to conceal the scale of the disaster. WorldCom, which "misclassified" $3.8 billion in network-maintenance costs as capital spending so as to hide huge losses, teeters on the verge of bankruptcy. If it goes under, it will be the biggest failure in business history, putting even Enron's demise in the shade.

The telecoms bust is some ten times bigger than the dotcom crash. It is crucial, for both financial markets and the world's economies, that the industry climb out of its hole

All this means that it is crucial, both for financial markets and for the world's economies, that the telecoms industry should now climb out of its hole. It faces years of painful reorganisation, as the oversupply of capacity built during the boom years is brought into line with demand, and the mountain of debt is restructured (see article). There will be more bankruptcies among erstwhile high-flyers. In America, there is a risk of a vicious circle: as companies emerge from Chapter 11 having shed their debts, they may undercut debt-laden rivals, causing further collapses. In Europe the former monopoly incumbents, such as Deutsche Telekom, which shed its chief executive this week (see article), can be sure that their governments will not let them fail. But they too must reduce debts by selling assets, backing out of loss-making overseas ventures to retrench in their home markets, and issuing new shares. On both sides of the Atlantic, once new management is in place and investors are reassured that no new accounting skeletons lurk in closets—not any time soon, in other words—an enormous round of consolidation must begin.

The likely winners, it is already clear, are the former "Baby Bells" in America and the former monopoly incumbents in Europe. Because they own the "last mile" of the network that runs into homes and offices, these operators have a firm grip on their customers and solid revenues. Compared with their upstart competitors that proliferated after the liberalisation of telecoms markets during the 1990s, these firms are relative safe havens. Customers can switch long-

The likely winners are the former "Baby Bells" in America and the

distance carriers at the first whiff of trouble, but often have no choice of local provider. In theory, regulators should require local monopolies to allow competitors to provide services over their lines, but most local monopolies have successfully obstructed such “local-loop unbundling” using a variety of technical excuses.

former monopoly incumbents in Europe

In a further sign that local operators are seen as a safe haven, Michael Powell, America's telecoms regulator, even signalled this week that he would consider allowing one of the Bells to buy WorldCom. The antitrust rules that now prohibit the Bells from fully entering the long-distance market might, in other words, be set aside. Meanwhile, the Bells are pushing for regulatory concessions that would let them establish new monopolies in high-speed “broadband” Internet access, and have won a number of recent victories.

With the upstart competitors flat on their backs and the local monopolies once more calling the shots, the telecoms landscape could soon come to look much as it did in the days before liberalisation. It is tempting to conclude that the natural-monopoly economics of telecoms have simply reasserted themselves—and that liberalisation was a big mistake.

Let 1,000 bells ring

Tempting, but wrong. Liberalisation has provided unquestioned benefits for customers. The emergence of competitors has compelled former monopolies to stir themselves, cut prices, introduce new services, and abandon any notion that the world owes them a living. Look at the way the cost of long-distance calls has fallen in recent years, or how the popularity of mobile phones has grown. Both are direct results of competition. It is true that the bust's ultimate cause was that too many competitors decided to build enormous networks for which there was little demand. But that does not justify a return to the industry's monopolistic past.

The danger is that the traumatic scale of the telecoms crisis will cause the pendulum to swing back too far in favour of the former monopolies. In the short term, they are likely to attract investment, to pick up the assets of bankrupt rivals, and to lead the way in consolidating the industry. This will provide some welcome stability. But it would be wrong to grant the former monopolies any regulatory concessions now that would protect them from competitors in future.

It is tempting—but wrong—to conclude that liberalisation was a mistake

Once today's bust is over, too much power concentrated in the hands of the former monopolies could let them raise prices and stifle the deployment of innovative technologies. The one thing that keeps would-be monopolists on their toes is viable competitors. It may be hard to imagine just now, but such competitors are sure to re-emerge in telecoms one day. And when they do, governments must ensure that the regulatory door has been left open to let them in.

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Zimbabwe

Booting out the messenger

Jul 18th 2002
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Robert Mugabe tries to banish our correspondent

Get article background

Reuters

FOR the sake of balance, here are some of Robert Mugabe's virtues. He dresses stylishly. He is sincerely fond of cricket. His government is less crooked than Liberia's, and less murderous than Sudan's. After 22 years under Mr Mugabe, Zimbabwe is in better shape than Congo or Angola. But there ends the list, and also the part of this article that could be published in Zimbabwe without fear of prosecution.

This week, *The Economist*'s (and the *Guardian*'s) correspondent in Harare, Andrew Meldrum, became the latest victim of Mr Mugabe's campaign to shackle the media. The week started well: Mr Meldrum was acquitted of publishing a falsehood. This charge, which carries a maximum penalty of two years in jail, can be levelled at any journalist critical of the Mugabe regime who makes a factual error, but is not, of course, wielded against those who peddle tosh on otherwise dreary state news bulletins. We applaud Godfrey Macheyo, the magistrate who exonerated Mr Meldrum, thus proving that Mr Mugabe has not yet forced out all the honest members of the judiciary. But Mr Macheyo's courage may prove in vain: as Mr Meldrum walked out of court, he was served with a deportation order. He appealed, and won leave to take his case to the Supreme Court, which could take some months. We hope that he will be allowed to fight the case without intimidation—a courtesy denied to some other correspondents.

Mr Meldrum has lived in Zimbabwe since the year Mr Mugabe came to power, and has seen the country transformed from a land of hope into one of fear. Mr Mugabe seems to believe that, because he led the successful revolt against white rule in the 1970s, he has the right to reign forever. So long as his grip on power was not seriously threatened, he allowed his subjects a fair degree of freedom. But he did not hesitate to slaughter thousands of suspected rebels, most of them innocent, in the mid-1980s. And now, when it is clear that a large majority of Zimbabweans want him to go, he feels compelled to rig elections, criminalise dissent, torture dissidents, and even block the delivery of food aid to opposition-supporting victims of the famine his policy of persecuting commercial farmers has created.

The world watches and weeps

What can be done to stop him? “Smart” sanctions, freezing the assets and restricting the movements of the ruling party's top thugs, seem to have made little difference. Wider trade sanctions would hurt Zimbabwe's productive citizens more than their leech-like rulers. Mr Mugabe does not care if the country reverts to subsistence farming, so long as he remains in charge; he would hardly be swayed by an embargo. He might listen to criticism from his African peers, but that is not forthcoming. The newly created African Union is supposed to uphold the principles of democracy and good governance on which Mr Mugabe so brazenly tramples. But he is not the only offender, and even Africa's better leaders resent the attention the West pays to Zimbabwe, which they correctly surmise is proportional to the number of whites caught up in its turmoil.

As in most tyrannies, change in Zimbabwe will have to come from within. Since most avenues for peaceful protest have been blocked, there is a growing fear that the endgame may be bloody. We pray

that it will not be. But however events unfold, and whether Mr Meldrum is allowed to remain or not, we will continue to cover this unfortunate country.

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British public spending

Rewarding failure

Jul 18th 2002
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The Treasury aims to spend more and get better value for money. It will succeed in the first

Murdo Macleod

Get article background

IF ORDINARY citizens took as much satisfaction in ever-rising quantities of public spending as Gordon Brown does, Britain would be the most contented country on the planet. The chancellor of the exchequer, who announced new three-year spending plans on July 15th, positively luxuriates in his generosity with other people's money. As a spectacle, it is certainly indecent. Is it bad policy?

Mr Brown, one has to acknowledge, spares no effort to prove otherwise. Public spending, he confirmed, is planned to rise from £420 billion ($650 billion) in the current fiscal year to £510 billion in 2005-06, a rise of £90 billion, equivalent to an additional £3,600 a year for each British household. A very large increase, Mr Brown boasted, but one he says is both financially sound and guaranteed to be cost-effective. He expects to pass his self-imposed fiscal tests—keeping the current budget in balance over the course of the economic cycle, and holding public-sector debt at 40% of GDP or less—without difficulty. And he and his officials continue to pile objectives, targets, contracts, charters, watchdogs, commissions, inspectors and auditors on anything that moves. Value for money is paramount, Mr Brown assures. Additional funds will go to programmes that work; failure will be starved (see article).

For the time being the macroeconomic arithmetic does appear to add up. The Treasury's growth forecasts are getting a bit less cautious with each passing year, but Mr Brown still has a pretty comfortable margin for error. It helps that the chancellor forgot to include in his fiscal tests an upper limit on taxes as a proportion of national income—the most important test of all—so that revenue shortfalls, if the economy fails to grow as strongly as he expects, can be made up with further rises in taxes. On present trends, this should not be necessary during the three-year planning period. If the planned rate of growth in spending were maintained beyond that, higher taxes would most likely become necessary. Still, if the government's increasingly Byzantine machinery of control and supervision worked as intended, even higher taxes and even higher public spending might be both popular and justified. *The Economist* continues to think this approach will fail.

The productive Mr Brown

The core of the value-for-money promise is the public service agreement (PSA), which sets goals for improvements in services department by department. If nothing else, these appear to have added to the stress of a career in the civil service (see article). In other ways, they are proving less satisfactory. The quantitative targets, typically for progress achieved by some distant date, seem to have been chosen with no clear rationale, and the qualitative targets mean little to begin with. Goals are already moving around in puzzling ways. In its previous PSA, issued in 2000, the overall aim of the Home Office was: “To build a safe, just and tolerant society, in which the rights and responsibilities of individuals, families and communities are properly balanced, and the protection and security of the public are maintained.” This year the goal has been refined and improved to: “Build a safe, just and tolerant society.” (By 2004, after further work by officials, the goal of the Home Office may simply be: “Build a society.”)

The Home Office's day-to-day responsibilities do at least belong with the

For all Mr Brown's

government. In other areas—notably in health and education, which account for much of the increase in overall spending—targets set and enforced in Whitehall are no substitute for actual economic incentives and empowered buyers of services. The health service has already seen a big increase in spending in recent years, but its outputs have been growing more slowly than its inputs: its productivity, in other words, is falling. For all the chancellor's emphasis on efficiency, the government has set its face against reforms that would free producers from central control and oblige them to compete. Vastly more money is being spent in a rush on a fundamentally unreformed public sector. Whenever and wherever this has been tried, the results have been bad.

talk of efficiency, the government seems set against reforms that would free producers from central control and oblige them to compete

Mr Brown has a PSA of his own, by the way. His aim, for which he will be held strictly accountable to himself, is: “Raise the sustainable rate of growth and achieve rising prosperity and a better quality of life, with economic and employment opportunities for all.” The sustainable rate of growth is driven by the trend of productivity. On this key measure, on which all else depends, how is the Treasury doing? Not too well, so far. Between 1979 and 1997, GDP per employee went up at 1.9% a year. Since 1997, a period which saw a marked acceleration in the growth of American productivity, it has gone up by just 1.3% a year. The British economy is falling further behind. This looks like failure. Why then is Mr Brown rewarding himself with £90 billion a year of additional resources?

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Turkey's crisis

Another fresh start, please

Jul 18th 2002
From The Economist print edition

Turkey and its well-wishers must not give up on reform

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Reuters

THE mantra that Turkey is a strategic pivot in a combustible bit of the world and has for the most part been an admirably calming influence in the region has never been more true. All the more worrying, then, that for the past few months its government has ground virtually to a halt and that nobody has been properly in charge (see article). The country desperately needs a firmer hand, though not of the kind that would spike its frail democracy. The expected (and welcome) departure of the country's ailing prime minister, Bulent Ecevit, will be only a first step. Turkey's torpid political air needs clearing, even if the general election now on the cards looks like bringing a mildly Islamic-minded party to power.

Turkey is important because it sits on the faultline between Europe and Asia; because of its history of imperial sway in the Balkans and in the Middle East; and because since the first world war it has modernised itself, albeit somewhat stutteringly, under Kemal Ataturk and his secular-minded successors. Despite the periodically frightening fragility and murkiness of modern Turkey's politics and economics, it is the most democratic of all the Muslim countries that lie between Pakistan and Morocco. For four decades it has been seeking to join the European Union and its forerunners. It has been a steadfast friend of the West as a strategically vital member of NATO. It has good relations with Israel. If the United States were to start a military campaign to oust Saddam Hussein from his leadership of Iraq, Turkey might well be a crucial launch-pad for the operation. If it were now to collapse into political and economic chaos, the consequences within the country and the region could be dire.

Its economy, which grew apace in the early 1990s, has been in a hole for nearly two years. Under the IMF's tutelage and with a sensible economics minister in the person of Kemal Dervis, it has been tentatively pulling itself out. But the government's paralysis under Mr Ecevit has threatened to push it back into the pit. If the IMF were to shelve its present plan to rescue Turkey with conditional loans worth $16 billion, the hardship under which Turks are already suffering would greatly increase and political extremism might surge.

That's democracy

Even when the economy has been steadier, Turkish politics have been fraught with danger. The country's generals, who view themselves as guardians of Turkey's secular state and still wield far too much influence on public affairs, are wary of an early general election lest an Islamic-minded party should win. Western governments had hoped that a new coalition would take shape within the present parliament, with liberal and EU-minded reformers such as Mr Dervis at its heart. But these reformers might have been hard pressed to command a majority in parliament. An early election is now probable.

And if the Islamists, who nowadays disavow the label, win? So be it. They are milder than their brethren elsewhere in the Muslim world. Their leader says he would keep Turkey in NATO and may even preserve his country's westward tilt. Western governments, for their part, can help by reassuring Turkey that the door to the EU is still open, while reminding the generals that their interference in politics will not help Turkey go through it. At the end of this year, at the EU summit in Copenhagen, Turkey should be invited

to start negotiating in earnest to join the club, provided it has by then enacted a promised and much-debated swathe of reforms to address human rights and, among other things, give Kurds more freedom.

Even if the present crisis is overcome, many Europeans doubt whether Turkey will ever qualify to join the Union. It would be a very long haul. It could take another generation. But the country has come a long way, in economics and politics, since the early 1980s, when it was an outright military dictatorship. Governments in the EU would be foolish to slam the door in the Turks' face. Their country needs help, albeit tightly conditional, not a cold shoulder.

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Stock options

Use and abuse

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The trouble with options

WHEN it comes to reforming corporate governance, America's senators are sensitive souls. This week, they wrangled for many hours about whether companies should be required to treat stock options as a business cost—and then ducked the issue. “We need to be careful about what we're doing,” said a nervous Senator Phil Gramm. Oh dear. Pay is a potent part of America's angst about corporate misbehaviour (see article), not surprisingly since America's chief executives are vastly better paid than any other country's. Their rewards have raced ahead mainly because of a greater use of equity-based pay. Yet now, it transpires, some not only mismanaged their companies but defrauded investors too. And some of the blame should fall on the way top managers are rewarded.

For now, the accounting and tax treatment of stock options hogs the debate, and not just in America. The International Accounting Standards Board is drafting rules requiring companies to treat options as expenses from 2004. If the European Commission is made of sterner stuff than America's Senate, the rules will apply to all European public companies by 2007.

The idea that options should be anything other than a cost has never been easy for simple folk to grasp. Nor sages: as Warren Buffett, America's most famous investor, once asked, “If stock options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world do they go?” Not surprisingly, two companies that have recently decided to treat options as expenses, Coca-Cola and the Washington Post, both have Mr Buffett on their boards.

Might the sage of Omaha be wrong? Setting a value on options is tricky, but so is valuing other business expenses, such as leases or goodwill depreciation. One main effect of issuing options, the dilution of other shareholders, works more like a rights issue (which is not expensed) than mere pay. But unlike such equity issues it normally involves big financing costs as companies borrow money to buy back the shares that they then sell to option-exercisers. Another response to Mr Buffett's question is that markets know what options are worth, so they already build them into the share price. The past few days have provided some evidence to back up this view: Coke's announcement did not drive its share price down. But if markets are really so efficient, why should businesses fight the accounting change? And as that argument against “expensing” falls away, a powerful argument in favour remains. It is that even if markets know the real cost of options, managers doubt that they do. Almost invariably, reports Brian Hall, a Harvard Business School professor who has interviewed about 100 senior managers on the subject, they believe that because counting options as a cost will cut their reported profits, it will also dent their share price.

Even though options are not treated as an expense, grants of shares are. This discourages companies from using equity itself as an incentive. Yet restricted grants of company stock have advantages over options. When options' exercise prices are above the current share price (as about one-third were, reckons Mr Hall, even at the height of the boom in 1999, and far more are today), they offer little or no incentive. Incentives work best when they pay out smoothly in line with effort. Even a bombed-out share price holds out the hope of a tangible reward. When options become worthless, companies are tempted to reward demoralised executives by granting more.

The incentive to fiddle

Reforming the accounting (and tax) treatment of options is likely to make companies more hesitant over giving bosses excessive awards. There is, though, another reason for change: that the use of equity-based pay has created perverse incentives. The abuses that have besmirched corporate America were the work of managers whose wealth depended on propping up their company's share price—by any means, and in the fairly short term. Create a strong incentive, and managers respond strongly.

Equity-based incentives were an improvement on the total absence of any executive stake in a company that characterised the 1970s and early 1980s. No sage would want to return to that. But the cost of incentives should be fully disclosed, and all—whether options or straight equity—should come with restrictions that force managers to hold their assets for a long period, preferably five years. The ability to keep on cashing out is what tempted some to fiddle the books. And, just as shamefully, to sell out shortly before their firms collapsed.

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Letters

Jul 18th 2002
From The Economist print edition

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The Arab regions

SIR – It is a traditional error to use the artificial ideological concept of an "Arab world" as an object of analysis ("Self-doomed to failure", July 6th). The Arab world does not exist as an economic or political entity as such and one can argue whether it represents a cultural entity. Thus it is wrong that the Arabic-speaking countries are one region which can be studied and analysed statistically at an aggregate level. Comparing the economies and societies of Djibouti and Morocco is like taking Europe as one entity and measuring its economic performance and social development from Armenia to Ireland.

There are three Arab regions—the Maghreb, the Mashreq (from Lebanon and Egypt to Oman), and an isolated periphery consisting of Mauritania, Yemen, Somalia and Djibouti. If we look at the exchange of people, trade and capital within these regions a much brighter picture will emerge.

Sami Mahroum
Toronto

SIR – The UN's report on Arab countries reinforces the frustration of those Arabs who opted to come back to these places after receiving an education abroad. The brain-drain exists and is exacerbated not only by the factors you mention but by a feeling that one will regress rather than advance if one chooses to return to this part of the world.

Ignorance caused by poor education and widespread poverty is what breeds militancy and we have only ourselves to blame for any shortcomings. How can we expect respect and understanding when we fail to listen to or comprehend the needs and imperatives of our own people?

Massoud Derhally
Amman, Jordan

SIR – You jump to the conclusion that Islamisation has impeded the Arab renaissance. The Arab world today with its lack of knowledge and freedom, and denial of women's rights, is not much different from that of the quarrelling Arabs before the arrival of the Prophet Muhammad. As Caliph Omar said at the start of the radiant Islamic renaissance, "we are a people that Allah has glorified with Islam, and whom He shall degrade if we stray away from it."

Ahmed Abu-Abed
Ottawa

A fair bill for farmers

SIR – I must express my concerns about your recent reporting on new American farm legislation ("Always with us", June 15th). For instance, in your article on the World Food Summit you allege that the farm bill would cause massive overproduction to the detriment of poor countries. I am aware of no analytical evidence to support this and you cite none. In fact, a quite compelling argument to the contrary can be made. Our acreage base has remained relatively stable at about 325m-330m acres since the mid-1990s. The farm bill contains few new incentives to expand overall acreage or to encourage crop shifts.

Charges that the new law provides a radical increase in spending fail to recognise that Congress approved assistance packages boosting farm income by roughly $7.5 billion in each of the past four years. The farm bill continues support at almost exactly the same level: $7.4 billion per year. It is thus hard to argue that we will see any supply response that we have not already seen in the past four years. The only significant difference will be that our farmers are now able to plan for the long term.

The bill is also completely within our WTO obligations. Our domestic support ceiling is relatively low at only $19.1 billion, compared with $31 billion for Japan and $62 billion for the EU. To ensure that there is no violation, the new law mandates the agriculture secretary to use “circuit breakers” to ensure that the ceiling is not exceeded.

The charge that the new law restricts access to the American market or is protectionist is equally incorrect. It neither creates new tariffs nor changes quotas nor in any way restricts access to the very open American market. As for dampening our ardour for a successful agreement at the upcoming Doha round of trade talks, the new farm law, if anything, provides even greater impetus for our negotiators. A successful round would improve our market-access possibilities—our top priority—and greatly facilitate garnering support for any required modifications in domestic support.

J.B. Penn
Under-secretary of agriculture
Washington, DC

Medalling bureaucracy

SIR – It is now common to see the Presidential Medal of Freedom referred to as “the country's highest civilian honour” (Obituary, June 15th). It happens that I worked up the presidential medal for President Kennedy and the award was meant to be the highest civil honour, not reserved for civilians and separate from the military-honour system. My model was the Order of St Michael and St George, struck to celebrate the British occupation of the Ionian islands in 1818. Disraeli found some in his desk drawer and started passing them out to his new civil servants.

Daniel Patrick Moynihan
Washington, DC

Conspiracy of silence?

SIR – It is curious that although you blast Joseph Stiglitz in a review of his new book (“Bad faith”, June 8th), and follow up with an Economics focus (July 6th) praising an anti-Stiglitz blast by Kenneth Rogoff of the IMF, both you and Mr Rogoff completely ignore the key point that he makes: the IMF and Wall Street work together in a partnership designed primarily to serve the interests of the financial community. Is this charge so obviously true that it does not need a rebuttal, or is it too sensitive?

Mr Rogoff and *The Economist* vigorously defend Stanley Fischer, the IMF's former number two who has now joined Wall Street, as a person of unimpeachable integrity. Again it is curious that you both completely ignore the basic policy issue of whether the revolving-door for top officials in the relationship between Wall Street, the Treasury and the IMF is wise and beneficial to the general interest.

Robert Senser
Editor
Human Rights For Workers
Reston, Virginia

Fraudulent qualifications

SIR – You imply that a lack of certified public accountant certification among certain chief financial officers has contributed to the recent spate of corporate scandals (“Too creative by 50%”, July 6th). You miss the point completely: what these CFOs lack is integrity. If anything, a CPA has an even greater set of tools with which to cook the books and hide his tracks. A CFO without integrity will make every effort to defraud his company. Whether he has a CPA certification or merely a high-school diploma is only an indicator of how soon he is likely to be caught.

Greg Anderson

San Francisco

SIR – Your information on the changing qualifications of chief financial officers has scuppered my attempt to update the definition of my job as an economist to “one who is good with numbers but lacks the creativity to become an accountant.”

Jason Christian
Davis, California

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Turkey in trouble

More than enough to worry about

Jul 18th 2002 | ANKARA AND ISTANBUL
From The Economist print edition

Alamy

Feuding politicians and a fragile economy in a place that is strategically more vital than ever

Get article background

OSMAN is not much interested in the interest rate on 238-day Treasury bills: over 75%, up from 50% two months ago. He has bigger worries. One, he couldn't get aboard the overcrowded bus to his little self-built house, glued improbably to the rocky hillocks around Ankara, in defiance of the laws of gravity and the state. Two, as he explains via the German of a taxi driver returned from Essen, last year—when GDP fell by 7.4%—he lost his job, even though, officially, like his house, it didn't exist.

Why? He blames the government, a bunch of Americans called the IMF, some politicians, among them Kemal Dervis, minister of the economy and darling of the Fund and of western media. And the prime minister, Bulent Ecevit? Osman's own German is sufficient for him and the lot of them: they're *kaput*. And a country of 68m, a long-term ally of the West, in a vital area, may be deep in trouble too, just when its recovering economy can't afford political weakness and its key ally, the United States, wants its solid help against Iraq.

Even before the 77-year-old Mr Ecevit fell ill, and, many thought, incapable of governing, two months ago, his three-party coalition was creaking. Mr Dervis was one reason. A non-party man, he was drafted in from a World Bank post in Washington, in March 2001, after a monetary crisis provoked by a squabble between Mr Ecevit and President Ahmet Necdet Sezer. He has begun to put right the things—far deeper than a flurry in the markets—that needed it: notably the public-sector deficit and industries, and a weak, often misused, banking sector. He also added a strong voice to the many, in government as among the public, who see joining the European Union as the long-term answer to Turkey's multiple woes. But the farther the country advanced on these roads, the unhappier some of the government's parliamentarians became; mainly Mr Ecevit's Nationalist Action allies, but also some in his own Democratic Left and Motherland, the smallest party of the coalition three.

Then Mr Ecevit fell ill. This accelerated plots already afoot to replace the Nationalists with an opposition party, and the prime minister with—well, what about the foreign minister, Ismail Cem, thought, notably, Mr Cem? Two weeks ago, Mr Ecevit, sick or not, hit back: he gave Husamettin Ozkan, one of three deputy prime ministers and till then his faithful fixer, the push. A week later, after several ministers resigned, and his own rank and file began

fleeing the party, the crisis duly came. Mr Cem resigned. So did Mr Dervis, only to change his mind within hours under pressure from President Sezer and, covertly, Turkey's influential generals and the Americans.

Messrs Ozkan and Cem announced they would start a new party. Mr Dervis said he was with them in spirit, if not yet the flesh. The Nationalist leader Devlet Bahceli asked, fairly enough, why the economy minister was still in the cabinet and declared his usefulness over. And the political shenanigans got into top gear. With further defections costing the government its majority, this Tuesday brought news of an early election, given parliament, meeting in September, approves.

Misunderstanding—not only among foreigners—got into top gear too. Is the Ozkan/Cem/Dervis “troika”, acclaimed by some Turkish media, really a troika at all, let alone a party laden with policy prescriptions? Could it really sweep the country? Given the short time they now have to organise, not even its leaders truly think so. Is Mr Dervis really “the messiah” as some half-tongue-in-cheek journalists dub him? Well, he may have the right notions for the economy, but remember that only this spring, for a couple of months, a young diplomat, Mehmet Ali Bayar, late of New York, with the mini-party he had adopted, was being hailed by business as the new political wonder-man.

Economic magicians needed

Turkey could use some wonders. For all the energy and enterprise of people like Osman or the ex-émigré taxi-driver—more than 2m Turks now prove these qualities in Germany, no slackers' paradise—its economic woes can fill pages. For years it has run banana-republic levels of inflation: this year's target is to halve the 12-month rise by December—to 35%. The public sector in 2001 was 6-7% of GDP in surplus before interest payments. Fine? No: massive debt and fierce interest rates meant an all-in deficit of about 16%. The Turkish government pays far more (about seven percentage points more on 10-year money) than the American one on such dollars as it can borrow. Real rates on domestic debt, mostly rolled over short-term, are wild: over 30% last year. Nice work if you have capital to lend; in contrast, by early this year, real wages in manufacturing had fallen 17% in 12 months, and (official) unemployment was up three points to 11.8%.

These last few figures were the result of the IMF's fierce prescription to cure awful earlier statistics, the result of years of neglect, half-cures and sudden shocks that dashed the best intentions. The IMF agreed on a new prescription, sugared with dollars, with Mr Dervis soon after his appointment. A further dose came this February, with about $16 billion in standby credits, $12 billion of it new money. Because America needs Turkey so much strategically, it gets more IMF money than anyone else.

In his 16 months Mr Dervis has done a lot, often against grumbles in cabinet: “The biggest structural changes we've ever seen,” says one businessman. He has cut the central bank free from government, and let the lira float. Banks, often used as sources of easy credit for their industrial associates, have been fiercely audited by the banking regulator and forced to beef up their capital. Some were seized by the state and sold on. The latest to be grabbed, kicking and screaming, was Pamukbank, owned by the mighty Cukurova group. You don't pick a fight with Cukurova for fun. Other banks have been merged or, like one owned by Koc, another big conglomerate, shoved into the cash-laden arms of foreign partners. Private-sector banking is certainly a lot more solid than it was. The odd array of state-owned banks is being restructured for sale, one day: the first put on the market, last December, has yet to find buyers. Meanwhile, the state's Industrial Development Bank is arm-twisting heavily indebted companies and their bank creditors into deals that can get working capital flowing again.

The state's own industries have been pushed towards the real world: a crazy buying-up scheme for tobacco-growers has gone, and the state's monopoly drinks and tobacco “enterprise” is to be sold off. Ditto state sugar, also a monopoly, Turkish Airlines, and an oil refiner. Fixed-line

telecoms too, once they have been readied for long-overdue competition in, supposedly, 2004. Electricity generation and distribution are already being opened up, though the private sector is hardly rushing in.

In public finance, discipline, of course, is the cry. Public services are to be slimmed and taxes—"high if you volunteer to pay them"—reshaped, simplified and, that oldest of reformers' promises, better collected. Great, unless you are one of those directly affected. Mr Dervis's trouble is that some of his cabinet colleagues are: a bloated public sector or compliant state banks are nice places to find jobs for party supporters or loans for pals. Mr Dervis's efforts increasingly ran into swamps or brick walls: a blazing row with the then transport minister last year, for instance, over plans for Turk Telekom.

To business observers, Mr Dervis has achieved near-miracles. But they wouldn't bet much on his ability to go on doing so. "The secret is to make changes permanent," says one: "there is a tendency to slide back to the past." What he can now do before the election, let alone after, is open to doubt. This week, poor fellow, as the political storm clattered around him, he had to convince a visiting IMF team that reform was still on track. It had better be. Don't even hint at the word "default", but the Fund, though it still says Turkey will need only $4 billion from it over 2003 and 2004, must have bad dreams in which the word slips out.

The European dream, and its price

Yet it is politics that rules: not just the election and after, but, above all, Turkey's relations with the EU. It wants a firm date for the start of its access negotiations from the EU summit in December. Grant that, and the world will see Turkey set on the western road of modernism, democracy, free-marketing and prosperity, and confidence will soar. Refuse it, and gloom will flood in while foreign investors, already notably scarce this year, will not.

Yet here too the world misunderstands. Its faith in Mr Dervis's untried political skills may prove right. But the battle is no simple one between virtuous pro-western modernisers and baddies stuck with statism, inward-looking nationalism or headscarved Islam. You can be seriously Muslim, pro-EU and for free speech and human rights, as two substantial parties are. You can be free-market and thoroughly nationalist. You can be nationalist and western-looking, secular and suspicious of democracy, as the generals are (though they are no monolithic block these days, another misunderstanding).

The EU's terms for starting to negotiate include, notably: abolition of the death penalty; an end to the state of emergency aimed at Kurdish terrorism in the south-east; and, most controversially, the right to broadcast in the Kurdish language and a proper place for it (meaning what? few agree) in education. Separately, Cyprus is a big hurdle. The EU is ready—if not, Greece threatens to veto any expansion of membership at all—to bring the divided island in, if it must, with the first wave of candidate countries, even if the Greek Cypriots and Turkish ones cannot settle their differences. To most Turks, fed up with the issue though many are, this would be a slap in the face. For all their wildly overdone dreams of the economic joys of EU membership, the 65-70% support that this now has could crumble rapidly.

There is talk now of legislating to meet the EU's terms even before the election. Could be. The Nationalists will acquiesce, though basically they are against. The Democratic Left and its defectors are for, though Mr Ecevit's new foreign minister, till now minister for Cyprus, is a hardliner (a charge he denied this week in terms that proved it true). Motherland is dead keen. It sees the EU as a panacea. Give the Kurds an EU-enforced fair deal, and why would they want to separate? Bring Cyprus and Turkey in, and the island's squabbles would be “history” within 20 years, thinks Mesut Yilmaz, the party's leader, cheerily ignoring the several years which, at best, will lie between the two arrivals. Most of the opposition claims to be pro-EU, including the big True Path party. The generals, though divided, mainly oppose concessions on Cyprus. Let alone to the Kurds: “We beat them, why butter them up now?” And, however “western”, they fear losing the wide (and constitutional) political power and the public funds (not to say tax privileges for Oyak, their own business conglomerate) that they enjoy.

The result is a hodge-podge, and even this version is over-simplified. The picture is muddied still further by deep suspicion of the EU's sincerity. Does it really want Turkey, in today's anti-Muslim and anti-immigrant climate? The EU blames Rauf Denktash, the Turkish-Cypriot leader, for the stagnation, after six months, of the latest inter-communal talks in Cyprus. True, he is an obstinate old man, and the generals, who could arm-twist him, did so to get him talking at all, but gave him no map of how far to go. Yet, say the Turks, it takes two to disagree, and the EU, they argue, has not pushed the Greek Cypriots, promising them membership, deal or no deal.

This confusion should be no surprise. The EU issue is just today's face of much older history. Turkey was the centre of a great empire, now forcibly shrunk to its Eurasian rump; a once ruling people longing to be successful and be seen as such, yet knowing that they are neither. No wonder Turks fear the further “loss” of northern Cyprus—its territory, not just its people, who mostly, to judge from recent local elections there, are keener on a deal than Mr Denktash. Likewise Kurdish separatism. In neither case is there any Turkish version of the typical Briton's “can't be bothered” attitude to Northern Ireland.

And what is it to be Turkish? Turkey, once the seat of the Muslim caliphate, was ruthlessly secularised and westernised—not just modernised, like 19th-century Japan—by Kemal Ataturk not over centuries but within a few years. Is it Muslim? Or European? Can it be both? Does it want to be either? Is there a Turkish third way?

Reuters

Dervis and Cem, plotting hard

These questions intrude even into power politics. Turks are not Arabs. Their state is not Muslim. They've no sympathy with Saddam Hussein or al-Qaeda. Their army is in bed with Israel's. They have few friends save America, and depend on the American-influenced IMF. Yet when Paul Wolfowitz, Donald Rumsfeld's number two, was in Ankara this week to sell the idea of an attack on Iraq, he surely learned that few prominent Turks think that wise, and fewer still want Turkish bases used for it, though most accept that a country so in hock to the IMF will ultimately acquiesce.

The objections are practical. The Gulf war—which Turkey joined—cost it $50 billion (or some blue-sky figure) in later lost trade, the Turks claim. Worse, the resulting poverty in their south-east fed Kurdish terrorism. Third, they are terrified of any post-war Kurdish state, or even autonomy, in northern Iraq. Mr Wolfowitz soft-soaped them. What he could not answer, and perhaps was not told of, was an unease of spirit that a good many ordinary Turks feel, not as liberals or bleeding hearts or anti-Americans, but as Turks. Yet if a post-Saddam Iraq were back to its normal trading self, Turkey could benefit enormously.

The Erdogan phenomenon

The most striking example of Turkish ambiguity is the party now far ahead in the opinion polls, with 20-25%: Justice and Development, whose Turkish initials, not by chance, spell *ak*—white, or pure. Much of its appeal is just that: most of the old parties are seen as corrupt. The establishment wants to pin that label on the Whites' leader, Recep Tayyip Erdogan; a case against him, based on his years, 1994-99, as mayor of Istanbul, reached court on Wednesday. But his real crime is different: here, allegedly, is one of the dreaded Islamists.

You might think so. The generals, in what one called the world's first post-modern coup, eased out of power a government led by a veteran Islamic politician, Necmettin Erbakan, in 1997. His party was later

banned, as was its successor, and many of the latter's MPs defected to what is now Mr Erdogan's party. But he fiercely denies the Islamist label, and others agree.

The party, born last year, is one of conservative Muslims, yes; his own upbringing and political background was indeed Islamic (though his sons are at college in America); but, says a keen observer, the Whites “have learned from experience, and the appeal of modernity, that the old political Islam has no future.”

Visit the party headquarters, gleaming in a dowdy district of Ankara, and you could be in Europe: handsome young women, few of them trying and failing to conceal that fact with headscarves; bright young English-speaking aides—ambitious young American Republicans, you might think. Their leader is immaculately suited, elegant tie, striped shirt, his initials embroidered on the cuffs. Yes, flatly,Turkey should join the EU, on EU terms. No, just as flatly, its women don't get the education and jobs they deserve. Yes to wide-ranging privatisation. No to what he says is the increasing secularist strictness, like the ban on female university students wearing headscarves. In crude sum, an American view of the secular state: freedom for religion, not suppression. Yet is his party Islamic nonetheless? People have religions, he says; parties don't.

Mr Erdogan would, say his critics. For good measure, they add that being, as he was, an effective mayor of Istanbul is no test of the knowledge or skills for national leadership. Given Turkey's plight, one can think of worse.

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Another bad week for George Bush (1)

There must be some way out of here

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From The Economist print edition

AP

Americans are losing confidence in the economy. Can George Bush stem the slide?

THESE are not happy times for the White House. Share prices are tumbling, consumer confidence has fallen sharply and George Bush's own approval ratings seem to be heading down. For an administration haunted by the ghost of George Bush senior, whose defeat in 1992 was blamed on a sluggish economy, the parallels are becoming painful, not least because the current president's efforts to reassure Americans are also falling flat.

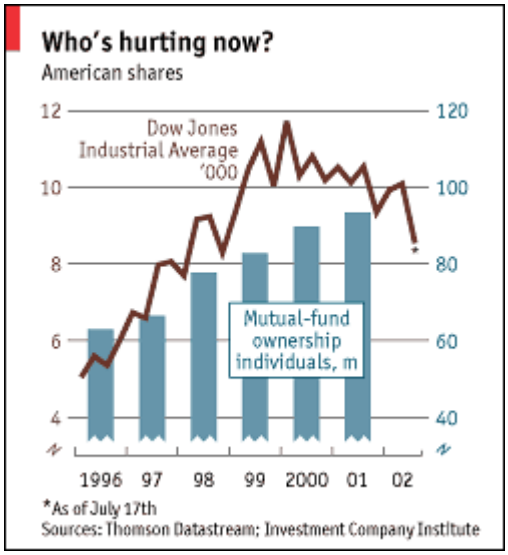
Mr Bush's trip to Wall Street to preach about corporate ethics was widely derided as too little, too late. This week's follow-up, a hastily-arranged pep talk on the economy in Alabama, proved another embarrassment. “This economy is coming back,” boomed Mr Bush. “That's the fact.” Meanwhile, in one of Wall Street's more dramatic days, stockmarkets slumped (though they recovered somewhat after he finished). It was all too close to Herbert Hoover, who famously proclaimed America's economy to be on a “sound and prosperous basis” in October 1929.

Judging Mr Bush's words by short-term movements in share prices is, of course, neither fair nor useful. The real questions are whether the White House has correctly diagnosed what ails the American economy, and whether its policies are right.

Mr Bush's basic contention is that the fundamentals of the American economy are in good shape. This was also the message of Alan Greenspan, chairman of the Federal Reserve, in congressional testimony the following day. At first blush, they have a point. Inflation is low and productivity growth remains surprisingly robust. Much of the excess investment that firms had built up during the boom has been worked off. Consumer spending remains surprisingly solid. Retail sales, for instance, rose 1.1% in June, far faster than analysts were expecting. The Fed has raised its forecast for economic growth in 2002 to 3.5-3.75%.

Yet despite these apparently good fundamentals, consumers are worried. The University of Michigan's consumer-confidence index fell sharply in July, to levels last seen in November. The main reason, of course, is the stockmarket slide (see article). Over the past two weeks alone the Dow Jones Industrial Average has fallen by 6%. The S&P 500 has dropped to levels not seen since October

1997. The technology-laden Nasdaq index is 72% below its peak in March 2000.



In large measure, this slide is the deflation of the 1990s bubble, a point Mr Bush himself hinted at: "America must get rid of the hangover that we now have as a result of the binge...we just went through," he said in Alabama. But it has clearly been aggravated by the slew of corporate scandals and the loss of investor confidence.

Sliding equity prices could begin to hurt those fundamentals, promoted so assiduously by Messrs Bush and Greenspan. Household saving, in particular, may be found wanting as Americans re-evaluate what they can expect from their retirement portfolios. That suggests a protracted spell of sluggish, rather than buoyant, consumer spending. Capital investment could also suffer, if firms become more cautious about borrowing.

Unfortunately, there are scant signs that the administration will help counter this. In his Alabama speech, Mr Bush promised an "agenda for long-term growth". This encompassed: fiscal policy (he wants to make his tax cut permanent, whilst forcing Congress to hold the line on spending); trade policy (he urged Congress to grant him "fast-track" authority to negotiate trade agreements); corporate reform (he touted his new Corporate Fraud Task Force, promised more money for the Securities and Exchange Commission, and urged Congress to send him an accounting-reform bill before August); boosting accountability in schools; and terrorism-risk insurance.

This grab-bag of assorted policies hardly constitutes a post-bubble economic agenda. Even if you thought it did, once you start going through the individual bits, the progress is patchy. For instance, the Senate certainly passed a tough corporate-reform bill on July 15th, and Mr Bush welcomed it. The next day Republicans in the House of Representatives promised to dilute many of the measures in the Senate bill (though they did agree to stiffer sentences for corporate criminals).

Nor do the prospects for trade policy look good. The Bush team has been pushing Congress for fast-track authority for 18 months. Legislation squeaked past the House of Representatives last December and the Senate in May. But reconciling the two bills has been difficult. If Congress does not get round to voting on fast-track by the August recess, the proximity of the mid-term elections in November suggests that the politically sensitive trade bill has little hope.

The biggest and most intractable problems, however, concern fiscal policy. Nobody seems to have absorbed how a post-bubble environment might influence the budget. On July 12th, the Bush administration announced that the federal government would run a deficit of $165 billion this year, compared with an earlier forecast of $106 billion made in February 2002. Although the economy has grown faster than expected since February, tax revenues have plummeted. Much of this revenue drop is due to the stockmarket, as individuals' capital gains have turned into losses. If the bear market lasts, so too will those revenue shortfalls.

In these conditions, Mr Bush's main fiscal policy—that his 2001 tax cuts, ostensibly to be reversed in 2010, should be made permanent—is hard to justify. If demand weakens substantially, there may be a case for more tax cuts (or spending) today. But it is hard to see the fiscal wisdom in making future tax cuts permanent at a time when revenues are so uncertain.

On spending, blame needs to be divided between the White House and Congress. Mr Bush talks tough on spending. He has threatened to veto a $27 billion supplemental budget bill that Congress has larded up to $31 billion. However, by agreeing to far larger, and permanent, expenditures (such as the massive farm bill) Mr Bush has lost the moral high ground. Congress, in turn, is closely divided, and short on any procedural systems for fiscal discipline. Finger-pointing and partisan bickering are far more likely in Washington than the confidence-inspiring policies that America's economy needs.

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Another bad week for George Bush (2)

What did he do?

Jul 18th 2002 | WASHINGTON, DC
From The Economist print edition

The whiff of cronyism surrounds the president's past business deals

THE Dow Jones Industrial Average is not the only thing looking like a punctured balloon. The air may be hissing out of George Bush's poll ratings, too.

Zogby International, a polling firm, says that only 62% of those it asked now think his performance "positive", the lowest figure since September 11th. To be fair, another poll, for the *Washington Post*, shows his approval rating almost unchanged at 72%. But the omens are not good. Thomas Riehle, the president of another polling outfit, Ipsos-Reid, points out that the number of Americans saying things are on the wrong track outnumber, for the first time this year, those who think things are going the right way. Fewer than half say they would re-elect Mr Bush if a presidential election were held today.

The revelations about the president's involvement in unsavoury business practices a decade ago have aggravated this vulnerability. The most commonly mentioned name is Harken Energy, a Texan firm where Mr Bush was a director.

In 1990, Mr Bush failed to obey the letter of the law in not reporting on time the sale of Harken shares. His excuse is that the lawyers ate his paperwork. In 1989 Harken partly obscured its real financial position by selling a subsidiary at a healthy profit to a group of Harken executives who borrowed some of the money for the purchase from the company. The Securities and Exchange Commission required Harken to restate its earnings. Mr Bush also bought some Harken shares using "sweetheart" loans from the company itself, a practice he now says should be stopped. Lastly, it turns out that ten weeks before the 1990 sale of those shares he signed a "lock-up letter", promising not to sell for six months after a proposed public offering. His spokesman says the promise did not stand when the public offering failed to go through.

None of this seems to be a WorldCom-class example of bilking the shareholders. There are two more worrying things for the White House. The first is an SEC investigation into what went on in the 1990s at Halliburton, an oil-services company, when Vice-President Dick Cheney was its boss. The firm used an accounting change to count as earnings a portion of income on some projects in dispute. Mr Bush has already been pushed into insisting that Mr Cheney will be exonerated. Whatever happens, Mr Cheney must regret his comments about his firm's accountants (wait for it), Andersen: "One of the things I like that they do for us is that...I get good advice...over and above the normal by-the-books audit arrangement." Whoops.

The second problem for the White House is that Mr Bush seems to have benefited from what Americans excoriated during the Asian financial crisis as "crony capitalism". Mr Bush's fortune came not from Harken but from his share in the sale of the Texas Rangers, a baseball team in which he invested using Harken shares as collateral. Three questions arise.

First, Mr Bush's stake in the team was 1.8%, which should have given him $4.5m from its sale. In fact he got $14.9m, because his partners gave up some of their share. As Paul Krugman, a columnist on the *New York Times*, points out, Mr Bush was then governor of Texas. Was this unethical?

Second, the price of the Texas Rangers soared partly because it got a new stadium built largely at taxpayers' expense. This was approved by local voters, but lawsuits allege that some of the land purchases involved were illegal. Is that true?

Third, the Rangers' buyer was Tom Hicks. As part of his "privatisation" of the management of the University of Texas's huge endowment, Mr Bush changed the rules so that the fund merely needed to

report its overall performance, not the details of each deal. Mr Hicks was the head of the investment firm that managed UT's money. Was there any link between this and the purchase of the Rangers?

Without more evidence, one has to assume the answer to all these questions is no. Moreover, many other politicians, Democrats as well as Republicans, have equally questionable episodes in their pasts, and worse things have doubtless gone on in Texas. Still, Mr Bush is a special case. He came into office promising to “change the tone” of Washington. His business travails are undermining his promise, and may yet cause Americans to see him as “just another politician”.

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John Walker Lindh

A murky end

Jul 18th 2002 | MILL VALLEY, CALIFORNIA
From The Economist print edition

The "American Taliban" pleads guilty, up to a point

AP

Marin man

IN THE afternoon sun, the little mosque in the Mill Valley Islamic Centre was deserted. The day before, on July 15th, its most notorious former congregant, John Walker Lindh, had pleaded guilty to two charges brought against him by the American government after he had been discovered, carrying two grenades and a rifle, among captured members of the Taliban in Afghanistan last December. The hush around Mr Lindh's former haunt fits the anti-climactic conclusion of his case.

For serving the Taliban and for carrying explosives, Mr Lindh will receive two consecutive ten-year sentences. He has agreed to co-operate with the government's inquiries, and to drop any claims that he was mistreated while in military custody in Afghanistan. For its part, the government dropped nine other charges, including several that could have carried life sentences, and agreed to consider letting him serve his sentence in a prison close to his family, who still live in northern California. Neither side was keen to proceed to trial: Mr Lindh wishing to avoid life in prison, the government to avoid scrutiny of its intelligence-gathering.

Some of Mr Lindh's former neighbours in Marin County, a famously liberal pocket of northern California, would have welcomed such scrutiny of the military-industrial complex. Suspicion of what the government is up to comes naturally at the Pleasure Principle, a Mill Valley store that invites patrons to "think interdimensionally—but shop here". Peering between the shop's clutter of marijuana pipes, pornography and stacked newspaper cuttings, a self-proclaimed "abstract writer and poet" frets that Mr Lindh's lawyers were not given a chance to interview other Taliban prisoners held at America's military base in Cuba. Mr Lindh is a "poor, misguided klutz", reckons a retired teacher, but his crimes were no worse than those of the government, which formerly gave aid to the Taliban in its efforts to eradicate opium.

The same point is made by Ebrahim Nana, a director of the Islamic Centre, who reports little surprise about the sentence. He sees gloomy confirmation of what he claims is the government's systematic bias against Muslims (though he acknowledges that local people have been enormously supportive since September 11th). Mr Lindh, whom Mr Nana remembers as an idealistic teenage convert, did nothing wrong, he thinks; it was his naivety that got him into a tangle.

Even in Marin, there are people who feel fury against Mr Lindh. Naive he may have been, argues one man at the Pleasure Principle, but at some point in his quest he should have realised that he was being asked to turn on his fellow Americans. For that, 20 years is a lenient sentence.

A trial would have cast more light on Mr Lindh's strange progress from bosky Marin County to the grim mountains of Afghanistan. But legal calculations have trumped dramatic satisfaction. Americans will have to wait for future trials to explore the murky borderland between violent treachery and acts justified by war.

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The International Criminal Court

Both sides lose

Jul 18th 2002
From The Economist print edition

In the end, America retreated a little—but nobody is particularly happy

Get article background

LIKE all good diplomatic compromises, it allowed both sides to claim some sort of victory—if they wanted to, that is. Weeks of bitter wrangling between America and its allies over the newly established International Criminal Court came to an end on July 12th, when the United Nations Security Council unanimously passed a resolution extending temporary immunity from the court's jurisdiction to America's UN peacekeepers.

The United States had shocked friends and foes alike when it threatened to veto the routine renewal of all UN peacekeeping missions, beginning with the mission in Bosnia, if the Security Council did not grant all UN peacekeepers a permanent immunity. The court's supporters on the council dug in their heels and refused to pass such a resolution. They were backed by all other council members, including even Russia and China, who themselves show no signs of joining the court.

The compromise eventually agreed was a resolution brokered by Britain. It extends immunity for 12 months to all soldiers or officials, from countries which have not ratified the treaty, who are involved either in UN missions or those authorised by the UN. This covers most international interventions.

America can claim to have gained protection for its personnel from politically motivated prosecutions by the court. It had originally sought permanent immunity, then a 12-month immunity that would be extended automatically, forever. Instead, it has had to settle for an immunity that relies on a specific provision of the court's treaty, and which has to be renewed by the council every 12 months. This means that any one of the council's five permanent members could veto a renewal, though this looks unlikely after all the fuss.

End of round one

Following the clash, feelings remained raw on both sides. While claiming to have won a “degree of protection” for Americans serving abroad, John Negroponte, America's UN ambassador, remarked that “should the [court] eventually seek to detain any American, the United States would regard this as illegitimate—and it would have serious consequences. No nation should underestimate our commitment to protect our citizens.”

The court's supporters insisted that it already features plenty of protections against frivolous prosecutions, and that the chances of any country's peacekeepers being prosecuted were virtually nil. What America had really been trying to do, they claimed, was to wreck an institution which it cannot control. “This is a sad day for the United Nations,” declared Paul Heinbecker, Canada's UN ambassador, after the Security Council vote. European ministers grumbled about American bullying. A coalition of human-rights groups complained that the council's compromise resolution twisted both the court's treaty and the UN charter.

Conflict over the court is unlikely to go away. The court has pretty wide support. The treaty establishing it has been ratified by 76 countries, including all members of the European Union, Canada, Australia and New Zealand. Since 1998, when the treaty was agreed, the court's backers have been trying quietly to soften America's opposition into indifference. Some even imagined that once the court had proved its worth, for instance by putting on trial an obvious villain, America might even decide to join itself. That now looks a forlorn hope.

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Rebuilding lower Manhattan

Six of the best?

Jul 18th 2002 | NEW YORK
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What next for Ground Zero?

AP

Come in, number three

DECIDING what to do with the 16-acre site on which the World Trade Centre once stood is being called the most sensitive question that New York city has ever faced. This week, after months of discussion, the Lower Manhattan Development Corporation (LMDC), which is responsible for the site, at last unveiled six designs. These have whipped up a tidal wave of comment, not all of it kind. More than 40m people tried to view the plans on the LMDC's website, overloading its server and slowing Internet traffic throughout the north-eastern United States.

Yet the biggest complaint to emerge about the plans is that they are too boring. Each includes a space for a memorial to the victims of September 11th, whose design will be chosen in another international competition. And each contains as much space for offices, hotels and shops as existed before the attack. The funkiest of the designs, known rather unfunkily as concept number three or Memorial Triangle, boasts an 85-storey tower that, with a broadcasting spire on top, could exceed the height of the former 110-storey twin towers. Most, however, are more modest than that, proposing between four and six smaller towers. The most popular of these in an early newspaper poll, concept number six or Memorial Promenade, features a grass park that would lead all the way down to the waterfront.

The plans, it is said, look a bit samey. This may be because they have all emerged from the same firm of architects, Beyer Blinder Belle (which did a nice job with Grand Central station). The LMDC's aim was to set a broad master-plan, and then let architects compete with innovative designs for the actual buildings (Beyer *et al* will be excluded from that part). Anyway, none of the concepts is expected to materialise in its drawing-board form. By September the six contestants will have been reduced to three; a winner will be announced in December.

That choice will be made by the LMDC in consultation with the Port Authority, which owns the site, and a series of other interested parties, from the mayor to the general public. One big squabble will be over whether it is right to cram so much commercial space into an area that has been losing business for some time. It took years for the original Trade Centre to become profitable, and there are now fears of creating a colossal white elephant. Plans to develop a transport hub are popular. But every New Yorker worth his bagel with cream cheese and lox has an idea about what the memorial should look like.

So far the LMDC's chairman, John Whitehead, has done a good job of keeping people together. But he will have his work cut out to keep this up. One leading New York politician jovially forecasts a long and bitter struggle, with all but the winner being cast cruelly aside. And that's if things go well.

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Transport in New York

No bus? Okay, a van

Jul 18th 2002 | NEW YORK
From The Economist print edition

The Big Apple may be able to survive a bus strike this autumn

NEW YORKERS with long memories, recalling the horrors of the 1966 and 1980 strikes, when their bus and subway systems ground to a halt, may be forgiven for getting into a panic last month when 1,500 bus drivers serving the borough of Queens walked out on their jobs. In a big area with only a few subway lines, buses are an essential part of the local transport network. To make matters worse, people in City Hall have been quietly preparing for a bigger, city-wide strike in the autumn.

In fact, the Queens strike has barely been noticed. This has a lot to do with what happened in the last big strike, 22 years ago. Then, opportunistic immigrants from the Caribbean bought whole fleets of used vans to carry stranded New Yorkers to and from wherever the official transport system would not take them. The van industry has slowly expanded ever since, eventually winning legal status and creating its own informal route system.

Since the current strike began, the Taxi and Limousine Commission has issued more than 1,900 new commuter-van permits. New York's mayor, Mike Bloomberg, quietly used his emergency powers to suspend the curious laws that forbid most cabs to pick up passengers from the street. Some entrepreneurial New Yorkers went an (illegal) step further, adding their unlicensed cars and vans to the pick-up parade.

The cost of a van ride, legal or not, is a very reasonable $1 (bus fares haven't been so low for a decade); cab rates are negotiated at the time of the journey. Even in rush hours, it is not too hard to find a ride, and some vans will provide door-to-door service. It has not, of course, been easy for everyone, especially the elderly; and some of the vans, particularly the ones operated by the new entrepreneurs, are truly wretched—packed, battered, airless, almost as bad as a crowded subway carriage.

Although the striking drivers work for private companies, they share their union with 33,000 employees of the state-run Metropolitan Transit Authority, which is responsible for the rest of the city's buses and its subways. These people are said to be planning a much wider strike in the autumn, over things like job security and health-care costs. But in view of the past month's events, is striking really the best way to make a point?

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About sponsorship

Health care and ex-servicemen

Senior service

Jul 18th 2002 | WASHINGTON, DC
From The Economist print edition

Old people looking for cheap drugs have found them at veterans' hospitals

AP

Battle honours include Merck, Pfizer and Glaxo

DESPITE a $50 billion budget and 220,000 employees, the Department of Veterans' Affairs gets hardly any public attention. A decade ago, a Senate aide famously compared visiting the department to Jules Verne's "Journey to the Centre of the Earth". Now it seems that another group of explorers has discovered the department: old people needing prescription drugs.

The department, known just about everywhere as the VA, oversees compensation programmes for retired servicemen and women. It has long been one of the best protected fiefs in Washington: ex-servicemen's lobbies are extremely powerful and few politicians want to be seen cutting support for men who have served in war. Yet the department now offers a good example of how a problem can move around the federal government—in this case from the failing Medicare system, the health-insurance programme for all elderly Americans, to the more sprightly VA system.

Since 1995, the VA's health-care system has seen an unexpected 46% jump in the number of patients making use of its services. For that it has to thank a package of laws passed in 1996. These smartened up the VA's 163 hospitals and broadened the services the department offers (including out-of-hospital care). The laws also made every one of the country's 25m ex-servicemen eligible for comprehensive care. Previously the service had been available only to poor and disabled vets whose health problems were a consequence of their time in military service.

From a financial point of view, this generosity was ill-timed. The largest group of living vets, from the Vietnam era, was then reaching illness-prone middle age, and the second-largest group, from the second world war, was beginning the equally costly process of dying.

The late 1990s were also a time when prescription-drug costs rose steeply for old people—particularly America's 9m ex-servicemen over the age of 65. The Medicare system covers medicine costs only for older Americans in hospital. With most private insurance plans demanding that people pay $10-40 per prescription and imposing all sorts of conditions, the VA's $7 for prescriptions started to look attractive. In the past five years the proportion of VA patients looking primarily for cheap drugs has increased from 2% to 21%.

Both parties are committed to expanding the Medicare system, but they cannot agree how to organise it or pay for it. The House passed a bill last month, and the Senate is debating the medicine issue this week. But none of the proposals is likely to become law in this election year. And, even when a law eventually emerges, it will hardly save the VA: any Medicare cover plan would find it hard to compete with $7 prescriptions.

So, unless the VA once again decides to pick and choose between the veterans it covers (something it is loth to do), it will have to start cutting services. In May the under-secretary for health in the VA, Robert Roswell, gave warning that the VA might have to shift money to pay for cheap drugs from that allocated to its traditional patients, such as paraplegics.

Cash for pills

Three other ways to save money present themselves. The most dramatic would be a long-mooted merger with the Department of Defence's health system. Both departments have always dismissed the idea. Military hospitals say they have to be ready to look after an army at war; the VA is closer to traditional patient care. On the other hand, the two departmentsoften operate hospitals and clinics within a few miles of each other: why not share medical equipment, neurosurgeons and bed space? A presidential task-force looking at this will report later this month. Congress also wants to start some pilot schemes.

A second way to save money would be to get rid of excess hospital space. Three years ago, a General Accounting Office report found that the VA was spending one in every four of its dollars maintaining its “medical infrastructure”, particularly in northern states that have lost patients to the warmer south. Attempts to redress this balance have been fought by suspicious veterans' interest groups. Frederick Malphurs, the VA man in charge of the assessment process, stresses that his aim is not to bring in bulldozers, but to rent out extra space to research organisations and private-sector hospitals.

The third possible source of cash is the new Department of Homeland Security. The VA is already part of the National Disaster Medical System and is the official caretaker of the national vaccine stockpile. It now thinks it can play an even bigger role, not least because the entire network is under the command of the federal government. In late May the House of Representatives passed a $100m bill to set up four VA research centres on chemical, biological and radiological threats. The Senate is making headway on a similar bill.

Even if all three of these ideas were put into effect, they might not produce enough cash to cover the drug bills. Some argue that Congress should simply pay for veterans' drugs through the VA: after all, its big chain of hospitals can get the pills at cheaper rates than Medicare. Others may wonder how on earth a department that was supposed to look after battered old soldiers is becoming a cheap pharmacy for retirees in Florida.

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Lexington

In praise of the unspeakable

Jul 18th 2002
From The Economist print edition

There is a little more to American business life than selfishness and greed

HAVING spent the past decade deifying business people, Americans are now bent on demonising them. Chief executives have been flung into the national dog-house to gnaw the bones left behind by paedophile priests and pestilential telemarketers. More than seven in ten Americans tell opinion pollsters that they distrust the bosses of large companies. A short passage attacking selfish corporate bosses is now *de rigueur* in political speeches on any subject, in much the same way that politicians of all sorts once dragged the Internet into everything.

This is hardly surprising. It is disturbing to see chief executives earning 300 times more than shop-floor workers. (Pierpont Morgan thought that the ratio should be no more than 20 to one.) It is nauseating to see bosses who have ruined their companies gorging themselves on stock options. But let's not get carried away. Seeing nothing but clay feet in those Gucci loafers is almost as foolish as idolatry. If American businessmen lead the world in filling their own pockets, they also lead the world in returning their wealth to the society that helped to produce it.

The landscape of America is littered with monuments to business philanthropy. Look at great universities like Stanford or Chicago. Or great art galleries like the Getty or the Frick. Or great medical institutions like Rockefeller University. Every one of them is the product of a large private fortune translated into a large public good. Andrew Carnegie and John D. Rockefeller were hard-faced men who destroyed their competitors and crushed trade unions. But they were also great philanthropists. Carnegie's dictum that “the man who dies rich dies disgraced” created a fashion among his fellow robber-barons for pouring money into universities, art galleries and medical schools.

For better or worse, this philanthropy has allowed America to tackle its social problems without building a European-style welfare state, and to embrace modernity without abandoning its tradition of voluntarism, decentralisation and experiment. The country did a remarkable job of creating a national infrastructure before the introduction of the federal income tax in 1913. And, even as the federal government grew, boosted by war, depression and idealism, America was careful not to allow the public sector to crowd out the voluntary one.

Contrary to those speeches from Washington, DC, the 1990s were not just about greed. The 1990s malefactors of great wealth, in Teddy Roosevelt's phrase, may not have matched the generosity of their

antecedents—not least because many of them were still very young. But they made a start. Bill Gates's endowment is now worth $24 billion. Ted Turner pledged $1 billion to the United Nations. Gifts of $100m or more went from being rarities to regular occurrences. Only the other day David Geffen, a music mogul, gave $200m to the UCLA medical school.

Anyone who thinks that there is nothing to American bosses other than unbridled greed should consider the example of Gordon Moore of Intel. Last year Mr Moore and his wife gave away $5.8 billion to their family foundation, as well as $300m to the California Institute of Technology, dethroning the Gates family as the country's most generous philanthropists. Having spent most of his life building up Intel, Mr Moore, a famously modest sort, now wants to devote the bulk of his fortune to protecting the environment and promoting health care.

The idea that wealth entails responsibility goes much deeper than billionaires. The richer Americans become, the higher the percentage of their incomes they are willing to give to charities. Americans with a personal fortune of $10m or more give away about 9% of their income a year, according to the Social Welfare Research Institute at Boston College; those worth $5m-10m give away 4.8%; and those worth $1m-5m give away 3.8%. (The average for the country is 2.2%.) American philanthropic contributions accounted for 1% of national income, compared with between 0.2% and 0.8 % in Europe. The “wealth hurdle” for “serious acts” of philanthropy, such as setting up a private foundation, is $20m in America, compared with $100m in Europe.

More is Moore's law

Relying on philanthropy is a pretty roundabout way of providing social goods. Some donations do look a little eccentric: witness the Californian couple who last year contributed $37m to a charity for homeless and injured animals, inspired by their miniature schnauzer. But the American system has virtues as well as vices. America's universities are gleaming palaces next to Europe's nationalised slums. America leads the world in medical research. The traffic in talent—in academics, scientists and artists—is all flowing in America's favour.

The American system is enormously creative: think of George Soros's efforts to help the post-communist world adjust to capitalism. The American system has also allowed the country to escape from the excessive centralisation of much of Europe. Two of last year's biggest charitable bequests will benefit Greenville, South Carolina, and Birmingham, Alabama.

What does America's great tradition of business philanthropy tell us about the current brouhaha over corporate malfeasance? First, that George Bush is not necessarily wasting his time in appealing to business people's better natures. America's philanthropic tradition owes far more to social pressure and genuine altruism than it does to tax breaks or government bullying. And, second, that the current controversy will probably strengthen the charitable impulse. In the short run, the rich will probably have less spare cash to pour into their foundations; in the longer run, they will probably redouble their charitable works, just as the robber barons redoubled theirs as the tides of Progressivism rose. If things go well, the current shake-out should provide America not just with more honest corporations, but also with rich businessmen who take their social responsibilities more seriously than ever.

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Argentina's presidency

Menem again? Surely some mistake?

Jul 18th 2002 | BUENOS AIRES
From The Economist print edition

The popular anger that toppled his predecessor has weakened President Eduardo Duhalde. With other politicians faltering, Carlos Menem could yet return

Get article background

EVER since rioting in Buenos Aires forced the resignation of President Fernando de la Rua last December, the average Argentine's sentiment towards his country's politicians has been summed up in the chant: *que se vayan todos*, or kick the lot of them out. In the popular view, corrupt and self-serving political leadership is the chief underlying cause of Argentina's economic collapse. So it would be supremely ironic if this corrosive hostility to politicians were to end up returning to power Carlos Menem, the most brazen representative of the species and the man who as president from 1989-99 bears prime responsibility for the disaster.

Unlikely though this seems, opinion polls suggest that Mr Menem is best placed to win the nomination of his Peronist party for a presidential election now expected to be held in March. That is not because of any sudden upsurge in his popularity. True, the former president's image has improved somewhat over the past month: 70% rather than 75% now say they disapprove of him, according to Ricardo Rouvier, a pollster.

Rather, Mr Menem's resurgence stems from the weakness, or reluctance, of other potential contenders for the poisoned chalice that is Argentina's presidency. Eduardo Duhalde, the man given the job by the Congress in January, has so far failed to reach an accord with the IMF, or halt an economic slump that saw GDP shrink by 16% in the first quarter of this year compared with the same period last year. Mr Duhalde's weakness caused him to bring forward the election, originally set for September 2003. Further unrest on the streets could see the vote held even sooner. Either way, the next president may have to take many of the unpopular decisions required to restore economic confidence which Mr Duhalde has shirked.

That seems to have helped to deter Carlos Reutemann, the Peronist governor of Santa Fe province. An honest and austere administrator, he was seen as the man likeliest to beat Mr Menem in the party primary due to be held on November 24th. But on July 10th he said he would not stand. Unless he changes his mind, that leaves Jose Manuel de la Sota, the governor of Cordoba and a free-marketeer. But his province is almost broke; he is even outpolled there by another hopeful, Adolfo Rodriguez Saa, a populist who declared Argentina's debt default when caretaker president for a week in December.

Hanging over the Peronist primary will be the destructive rivalry between Mr Menem and Mr Duhalde. In 1999, Mr Duhalde blocked Mr Menem's effort to stand for a third term. Mr Menem's pursuit of this goal was behind the fiscal deficits that helped to bring down Argentina's fixed exchange rate. Mr Duhalde in turn blamed Mr Menem for his defeat at the hands of Mr de la Rua. Mr Reutemann is said to fear being crushed between these two hostile wings of Peronism. There are fears that the Peronist primary could be marred by violent clashes between them.

But even if Mr Menem were to win the primary, would he win the presidency? The Peronists, who probably retain a solid minimum of 25% of the vote, look to be the strongest force, but by default. Mr de la Rua's Radicals have all but withered away. Two of his former ministers, Patricia Bullrich and Ricardo Lopez Murphy, are worthy candidates of the centre-right, but have little chance of being elected.

Or perhaps Carrio

Argentina's least unpopular politician is now Elisa Carrio, a former Radical turned populist firebrand. But her newly formed party lacks national organisation. She says she might not stand unless there is a wider political agreement to bring forward elections for Congress to coincide with the presidential contest. Ms Carrio's withdrawal would help Mr Menem, but might devalue the election.

Polls point to a run-off between Mr Menem and Ms Carrio. It is hard to see a strong government emerging from such a contest, in which many Argentines would abstain. Mr Menem's economic recipe is to adopt the dollar; that might provide short-term stability, but would be politically incendiary. Ms Carrio lacks serious policies for government, and would find it hard to engineer any recovery.

All of this puts greater onus on Mr Duhalde to lay the foundations of recovery before stepping down. His government has inched towards an agreement with the IMF. The main oustanding obstacle is what to do about the banks. The IMF wants deposits frozen last December turned into long-term bonds; otherwise, it argues, their release would precipitate high inflation. The government fears public hostility to this scheme. But its attempt to persuade depositors voluntarily to accept bonds has failed, with a take up of only about 15%. Both sides hope that an answer to this impasse may come from an advisory group of eminent central bankers, due to visit Buenos Aires next week.

Mr Duhalde claims that the economy has touched bottom: tax collection and industrial production have shown signs of improvement, and with imports depressed, Argentina had a trade surplus of $6.6 billion in the first five months of the year. But even if Mr Duhalde does clinch a deal with the IMF, which has begun to look a little likelier, it may not amount to much: enough money to prevent Argentina from defaulting on its debts to the IMF itself and to the multilateral banks for another year, perhaps. Much of the work of restoring confidence is likely to fall to the next government. The question facing Argentina over the next few months is whether the election can produce one capable of the task.

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Chile's economy

Trouble with the neighbours

Jul 18th 2002 | SANTIAGO
From The Economist print edition

Can Chile stay different?

Get article background

BEING Argentina's next-door neighbour has not been a comfortable position this year. Brazil's financial markets have been in turmoil, Uruguay has faced a bank run, and Paraguay and Bolivia have suffered recession and protests. But Chile, South America's fastest-growing economy in the 1990s, is once again standing apart from its neighbours, this time in its resilient financial stability in hard times.

In April, while Uruguay was seeking an IMF bail-out, Chile placed an international bond issue cheaply. And while Brazil struggles with high interest rates (even after a half-point cut on July 17th), on July 11th Chile's central bank cut its interest rate by three quarters of a point to just 3.25%, in a bid to stimulate growth. True, Chile's currency has weakened over the past six months, but by much less than those of its neighbours. And given Chile's reliance on export-led growth, and its low inflation rate, a moderate devaluation is a plus.

So what makes Chile different? Many things, including an open economy, relatively effective institutions and two decades of continuity in economic policy. But one crucial difference is Chile's fiscal solvency. In 1997-98, when financial troubles struck Asian countries, Chile was less well equipped to face “contagion”. Government spending and private consumption were outpacing economic growth. As Chile's terms of trade deteriorated and its current-account deficit widened, the Central Bank was forced to raise its interest rate to 19%, bankrupting many businesses and tipping the economy into recession.

Since then, a new government, headed by Ricardo Lagos, has reined in spending. It has made a medium-term pledge to restrict spending to a level that would give a budget surplus if output were growing at its full potential (currently reckoned to be 5%). It has also floated the exchange rate and opened up the country's capital markets. “If it weren't for those changes, Chile would be in recession today,” says Leonardo Suarez of Larrain Vial, a local investment bank.

But Chile is no longer thriving. This year, as last, economic growth will be less than 3%, down from 6-7% in the 1990s. Its dependence on commodity exports makes Chile vulnerable to slower growth in industrialised countries. Although the volume of exports increased, its export earnings fell by 5% in the first half of this year compared with the same period last year. Secondly, while foreign direct investment has fallen across Latin America this year, the drop has been particularly sharp in Chile. That is partly because of the weak price of copper; new mining projects are now mostly on hold.

The government has sensibly ruled out any dash for growth through fiscal stimulus. Given the ease with which confidence can evaporate in Latin America, continued fiscal prudence is essential, says Nicolas Eyzaguirre, the finance minister. There are other things the government could do. Chile still lags developed countries in education, for example. But for now, many Chileans may just be grateful that their country is not suffering the kind of turmoil that has engulfed their neighbours.

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Politics in Paraguay

From bad to worse

Jul 18th 2002
From The Economist print edition

Angry protesters take to the streets

Reuters

Gonzalez calls out the cavalry

FOR months, discontent has been smouldering in Paraguay. This week, it flared up again. In violent protests against the government of Luis Gonzalez Macchi, two people were killed, dozens injured and over 200 arrested. Angry crowds blocked frontier bridges with Brazil and Argentina. In Asuncion, the capital, protesters converged on Congress, calling for Mr Gonzalez to resign. On July 15th, he declared a state of emergency, only to lift it two days later after some heavy-handed policing quashed the protests. But the president's problems are unlikely to go away.

Paraguay, one of South America's poorest countries, has been sorely misruled by the Colorado party for decades. Thanks to ineffective policies, combined with endemic corruption, income per head has been sinking for the past five years. To make matters worse, this year Paraguay has been hit by the problems of its two big neighbours, Argentina and Brazil. The currency, the guarani, has lost 26% of its value since January 1st. Last month, Banco Aleman, one of the larger private banks, collapsed, prompting panic withdrawals from other banks. Citing “contagion” from its neighbours, the government is trying to persuade the IMF to lend it $70m. But the Fund is unimpressed.

As the problems have mounted, so have the protests. In May, after large demonstrations, the government scrapped the sale of Copaco, the state telecoms monopoly, and repealed the privatisation law. The case for privatisation was undermined by corruption allegations involving the president's relatives.

The government blames the latest protests on Lino Oviedo, a former army commander now living in Brazil. He is accused of fomenting (failed) coup attempts in 1996 and 2000, and of engineering the murder in 1999 of Luis Argaña, the country's vice president. In December, a Brazilian court turned down a request to extradite him. But he could be expelled if found to be behind any future protests.

Mr Oviedo wants to stand for president in an election due next year; once a pillar of the Colorados, he recently formed a new party, the National Union of Ethical Citizens, for the purpose. If he is allowed to stand, he could well win. Whether his turbulent populism would be an improvement on Mr Gonzalez's rule is hard to say. Chosen as a caretaker by Congress after Mr Argaña's murder, Mr Gonzalez has clung to power despite several corruption allegations. He wants to stand for the Senate in next year's election; success would grant him immunity from future prosecution.

Some Paraguayans hoped that change was finally on the way after Julio Cesar Franco, from the opposition Liberals, was elected to replace Mr Argaña two years ago. That was the first national electoral defeat for the Colorados since they seized power in 1947. Mr Franco supported this week's protest, but has proved ineffective in offering a political alternative. With such leaders, it is not surprising that Paraguayans are taking to the streets.

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Politics in Peru

Toledo tries again

Jul 18th 2002 | LIMA
From The Economist print edition

A search for political allies

Get article background

DEALT a body blow by a civic uprising in mid-June against the privatisation of an electricity firm in Arequipa, Peru's second city, President Alejandro Toledo has reacted by ditching several of his most important ministers. The cabinet reshuffle on July 12th is designed to shore up support for Mr Toledo's battered government among the public and in Peru's Congress, where he lacks a majority. In the short-run it may succeed, though at the potential cost of replacing promised fiscal austerity and state reform with modest helpings of old-fashioned pork.

Mr Toledo has called in as prime minister Luis Solari, who heads his weak Peru Posible party and was briefly his health minister. As finance minister, he has brought back Javier Silva Ruete, a veteran politician who held the same job in the caretaker government that preceded Mr Toledo's. Mr Silva replaces Pedro Pablo Kuczynski, who like the outgoing prime minister, Roberto Dañino, was seen by investors as a guarantor of fiscal austerity. But both men had lived for the previous 15 years in the United States, and had seemed out of touch with Peruvian politics.

Mr Silva is less orthodox than Mr Kuczynski, but is still seen by investors as a safe pair of hands: he is unlikely to allow spending to run amok. He is flexible enough to be on friendly terms with most of Peru's motley political groupings, and is unlikely to defy public opinion. Mr Toledo is also seeking to build bridges with APRA, the main opposition party. Allan Wagner, his new foreign minister, is close to Alan Garcia, APRA's populist leader; Fernando Olivera, the justice minister and an APRA foe, may be sacked.

The new cabinet's task is to steer Peru towards elections for new regional governments in November, while trying not to derail a modest economic recovery. Its approach will be pragmatic. Mr Solari ruled out any further privatisations until after the elections, even suggesting that they should be handled by the new regional governments. That would be a supine abdication of central authority. Concessions for private investment in roads and other infrastucture may also be shelved. And tariffs may be raised to placate industrialists. But further big changes are unlikely: the government is hemmed in between a fiscal deficit that looks likely to overshoot the target agreed with the IMF (of 2.2% of GDP at most) and a public intolerant of reform.

Mr Toledo may have defused some of the pressures he faces. But his critics see many of his problems as being of his own making, citing his rash promises and indecision. Neither has his evasion of a DNA test in a paternity suit brought by a 14-year-old girl done him any favours. He will need the support of foes as well as friends if he is to serve out his term, which is due to end in 2006.

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Conservation in Mexico

Cementing the natural heritage

Jul 18th 2002 | BOQUILLAS DEL CARMEN, MEXICO
From The Economist print edition

Private money comes to the rescue

SEEN from the Big Bend National Park, on the Texas side of the Rio Grande, the Sierra del Carmen rises abruptly from the vast reach of the Chihuahuan Desert, a dramatic 2,900-metre scarp of white limestone topped with rolling grassland and dark forests. Once the hideaway of Apache raiders, for the past half century it has been peopled only by wandering miners and goat herders. It is also the last redoubt of wildlife in northern Mexico: black bear and puma, jaguarundi and bobcat, perhaps even reclusive jaguars and ocelots, as well as feral cattle and horses. Now it has become the site of an unusual conservation effort.

Unusual because the would-be conserver is not Mexico's government but Cemex, a giant cement firm based in the northern city of Monterrey. Over the past two years, Cemex has bought huge tracts of land in the Sierra del Carmen. Its aim is to create Mexico's largest wildlife reserve.

In 1997, most of the area was designated as a national park. But nearly all of the land was in private hands. The park's rules so infuriated landowners that they barred government officials from entering. So wildlife remained unprotected. But drought, low cattle prices and exhausted mines meant that many landowners were keen to sell. Cemex stepped in: it now owns 136,000 acres of land, or over 60% of the National Park area, and plans to acquire the rest.

Why? “We know that we use a lot of natural resources in what we do. We want to give something back, and this is our opportunity,” says Armando Garcia, the Cemex manager in charge of the project.

Cemex has built an airstrip and plans a research centre and housing for park staff on land just outside the national park. It has fenced a large enclosure for breeding desert bighorn sheep. This will be used to re-stock areas in northern Mexico where native sheep have been wiped out. There are plans, too, for the re-introduction of javelina (wild boar), mule deer and elk. Cemex has also set an interesting precedent. Mexico has 140 national parks, but the government's budget provides adequate funds for only a tenth of them. The private sector could help to fill this gap.

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Sri Lanka

Smiles that conceal the worries

Jul 18th 2002 | COLOMBO
From The Economist print edition

Reuters

How the Tigers are taking advantage of a ceasefire

Get article background

IT IS almost six months since the Sri Lankan government and the Tamil Tigers agreed to end the island's civil war. On July 11th Yashwant Sinha, India's new foreign minister, made a quick visit to the island to inquire politely when peace talks are likely to begin. He is not the only one to be worried. Despite the smiles of Mr Sinha and Chandrika Kumaratunga, the Sri Lankan president, in our picture, there is no date yet for the two sides to start to find a permanent solution to a 19-year ethnic-based conflict that has resulted in some 60,000 deaths. The talks were due to start in May but have been put off several times. Optimists hope for an August date, with the talks taking place in Bangkok.

Optimists are also insisting that the ceasefire that accompanied a “memorandum of understanding” in February is holding. However, some 400 “incidents” have been reported to members of the Norwegian team that brought together the two sides and is now pressing for peace talks to start. Nearly all have been blamed on the Tamil Tigers. They include the murders of political enemies and the forcible conscription of children for the Tiger brigades. A member of the Norwegian team based in Batticaloa, in eastern Sri Lanka, where the Tigers are strong, said that every morning parents of abducted children came to the team's office in tears. In the east too the Tigers seem intent on bringing the Muslim community there to heel. Muslims account for 8% of the island's population and are a resolute lot. Clashes between Muslims and Tamils claimed 11 lives in June. Muslims said the Tigers were to blame. This is a place where fighting could break out again.

The delays to the talks appear to have been put to good use by the Tigers. The Tigers' leader, Velupillai Prabhakaran, has made it clear that he seeks a separate state for Tamils in the north and east of the country. It is difficult to imagine that any government of Sri Lanka could grant this in the face of opposition by the Sinhala majority. The most that is likely to be offered to the Tigers is an area where the Tamils would have a high degree of autonomy, but with the central government in Colombo in overall control.

However, Mr Prabhakaran appears to be in the process of creating a “shadow” Tamil state in areas under Tiger control. This has some resemblance to the statelet the Tigers once tried to create in the Jaffna peninsula before the government resumed control there. The name of their proposed state, Eelam, is on

their notepaper. Eelam has a flag and a national anthem. The Tigers have their own police, and enforce summary justice. They have set up banks, while a network of money-changers facilitates minor transactions. What they call a voluntary tax system is in place for goods and services, and tax collectors are said to have little trouble with slow payers.

All this is against the law. The central bank of Sri Lanka is the sole monetary authority in the island. The inland revenue is the sole authority for dealing with taxes. The government regards the Tigers' taxation as simple extortion.

Still, not everything is going the Tigers' way. They want the Sri Lankan government to lift a ban on membership of their organisation. But even if the prime minister, Ranil Wickremesinghe, agreed to this as a way to getting peace talks going, the Tigers would remain a terrorist organisation in the eyes of the United States and many other countries.

Since the September 11th attacks on New York and Washington, bank accounts held by the Tigers in the United States and other countries have been tracked down and frozen. About $4 billion is believed to be being withheld from the Tigers around the world. The Tigers believe that if Mr Wickremesinghe can at least give them legitimacy in Sri Lanka, the money could be unfrozen. However, the prime minister does not want to be seen to be easy on the Tigers. He is aware that many Buddhists, who comprise about three-quarters of the population of Sri Lanka, are against peace talks at all.

Senior Buddhist monks recently wrote to the government saying they feared that the Tigers' campaign for a Tamil state would lead to the extermination of Buddhism on the island. There are around 50,000 Buddhist monks attached to about 8,000 temples. They are powerful. The monks have their own networks and use them to combat any perceived threat to Buddhism. Mr Wickremesinghe comes from one of the leading Anglican families in Sri Lanka, and does not want to be seen as unsympathetic to Buddhist views. The prime minister will also be aware that India, the regional superpower, while wanting peace in Sri Lanka, does not want it at any price. Mr Prabhakaran is still wanted by India to stand trial for complicity in the murder of Rajiv Gandhi, a former Indian prime minister. Any deal with the Tigers would have to approved by India.

When the prime minister eventually meets Mr Prabhakaran at the negotiating table he will be encouraged that the Tigers' potential manpower is declining. Before the civil war began, the Tamils were 12% of the island's population. Since then almost 500,000 Tamils have moved from the north for more profitable pastures overseas, while 200,000 have sought refuge in southern Sri Lanka. As a result the Tamils are now only 8% of the population, the same as the Muslim community. This re-drawing of the ethnic map of Sri Lanka is a source of worry for Mr Prabhakaran.

Another worry is the emergence of local warlords in the north challenging the Tigers' power. The Tigers have enough fighters to cause trouble but not enough to police an area that amounts to about 13% of the island. This fact may be one of the better cards for the prime minister to play. He will need every one.

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Marshall Islands

The injured islands of the Pacific

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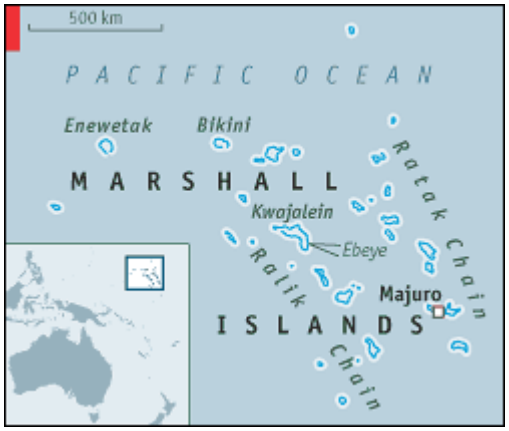
The destruction of Bikini and all that



WHAT strikes a new arrival to the Republic of the Marshall Islands is its feeling of prosperity compared with many other Pacific states. In Majuro, the capital, wharves and warehouses line the lagoon, and even the taxis have air conditioning. The housing is rather more substantial than the shacks of the impoverished atolls of south-west Micronesia, where the economy is still based on fish and coconuts. The United States has provided the Marshalls with more than $1 billion in aid since the country signed what was called a “compact of free association” with the Americans in 1986. The money goes a long way in a population of a little over 50,000. But no one doubts that they deserve it.

The United States took over the Marshall Islands after the second world war as part of a larger United Nations' trust territory. It then proceeded to use the remote atolls of Enewetak and Bikini as a test ground for nuclear weapons, making them uninhabitable. Between 1946 and 1958, 67 tests were carried out. Kwajalein atoll is the site of an American military base, and its radars and launch facilities have been and still are an important part of America's missile-defence project.

In the period from 1986, when the Marshalls became independent, to 1999, American payments for using Kwajalein ($180m), compensation for injuries arising from nuclear testing (at least $250m) and other agreed payments of $600m under the compact, accounted for most of the country's foreign-exchange earnings. Much of the money is spent on imports other Pacific nations cannot afford. Exports by the Marshall Islands pay for no more than 11% of imports. Naturally, the government wants more money. Not all places are like Majuro. Its affluence has been slow to spread through the region. Last year a government official acknowledged that Ebeye atoll was among “the worst ghettos of the Pacific”.

Over the years the traditional chiefs of the islands have controlled the country's affairs, watched over by their American benefactors. But in elections held in late 1999, allegations of corruption brought down a government headed by a major Kwajalein landowner, Imata Kabua. A commoner, Kessai Note, was for the first time elected president, heading a government committed to greater transparency and accountability.

Mr Note's support base is not on Kwajalein or the nuclear-affected atolls, but on the islands to the south and east of the group. Whether his government can survive in elections due in November 2003 may depend on the success of his present negotiations with the Americans on the renewal of their lease of the Kwajalein base for another 15 years. He needs to satisfy his constituents that they are being adequately compensated for playing host to some of the world's most terrible technology.

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Japan

Those dam politicians

Jul 18th 2002 | TOKYO
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A governor challenges the construction lobby

A STYLISH, youngish politician wins office and begins to break the rules. He promises to clamp down on public works projects, calling them a scourge rather than a cure for economic ills. When legislators with deep ties to the construction industry complain, he rejects consensus and continues to talk tough. He seeks support from the media. Voters approve of his maverick approach. Finally, he braves a vote of no confidence.

Has Junichiro Koizumi, Japan's prime minister, suddenly found his backbone? Alas, no. Instead, reformists must draw some hope from the drama playing out in Nagano, a rural prefecture north-west of Tokyo. On July 15th Nagano's governor, Yasuo Tanaka, announced that he will take on the prefectural assembly, which passed a no-confidence vote against him earlier this month, by calling a fresh poll and asking voters to re-elect him.

Since winning office as an independent in 2000, 46-year-old Mr Tanaka, Japan's youngest governor, has consistently pledged to rein in public-works projects in his prefecture. He triggered his showdown with the assembly, and became the first prefectural governor in a quarter-century to lose a confidence vote, by announcing in June that he will halt construction on two dams in the prefecture.

That decision infuriated Nagano's assembly members, many of whom, as elsewhere in Japan, enjoy close ties to the construction lobby. Because the central government pays most of the costs, Japan's profusion of highways, dams and bridges also tends to be a hit with rural voters, who have come to approve of the jobs and incomes those projects bring to slumping local economies.

After decades of runaway construction, however, these monstrosities often serve little purpose after they are built, and have overwhelmed much of Japan's natural environment. A recent book on Japan's concrete craze by Alex Kerr, “Dogs and Demons: Tales from the Dark Side of Japan”, claims that the government has dammed all but three of the country's 113 biggest rivers. Yet its enthusiasm for concrete is unappeased: an anti-dam pressure group claims the government plans to build 500 more dams over the next 20 years.

By contrast, the only flow that Mr Tanaka wants to block is the river of concrete that has been inundating the countryside. A prizewinning author and social critic, he has drawn on his personality and media savvy to gain support from ordinary households. To demonstrate his openness as a politician Mr Tanaka moved his office to a glass-enclosed room on the ground floor, so that all who care to can watch him at work.

Though he shares the prime minister's personalised approach to politics, Mr Tanaka's firmness stands in stark contrast with the political bargains Mr Koizumi has struck. The prime minister also came into office pledging to rein in public works. Yet despite some budget cuts, he has done little to dismantle the political machinery that keeps churning out these projects. Perhaps predictably, Mr Koizumi's cabinet secretary, Yasuo Fukuda, criticised the Nagano dispute this week, saying that “it would have been better...if the governor and the assembly had just talked to each other more”.

Will Nagano's voters back their governor's uncompromising approach? Mr Tanaka was supported by two-thirds of those questioned in a survey after the no-confidence vote. Yet his critics in the prefectural assembly reckon that his flamboyant approach may backfire with some voters. An important labour group that backed him two years ago seems unlikely to do so again. Moreover, the local economy is slumping badly after a public-works spending frenzy that accompanied Nagano's hosting of the winter Olympics in 1998. To those voters who are hooked on public works, the letdown may only stoke a craving for even more.

The best guess is that the governor is likely to win re-election. And though he would still have to do battle with the same assembly, Nagano's voters have a golden chance to send a message: that in at least one little corner of Japan, it is possible to draw a line in the wet cement.

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Kashmir

Why India did not bark

Jul 18th 2002 | DELHI
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Aftermath of the new attack in Kashmir

Get article background

IF THE militants who killed 28 people, including 13 women, in a slum near the city of Jammu in Indian-administered Kashmir on July 13th had hoped to cause an escalation in military tensions between India and Pakistan, they failed. Pakistan immediately condemned the attack and denied any responsibility, while India carefully avoided blaming Pakistan for aiding the killers.

This was in contrast to the situation in May, when the two nuclear powers came close to war after terrorists opened fire on a bus outside an army camp in Jammu, killing over 30 people, mostly soldiers' wives and children. Atal Bihari Vajpayee, the prime minister, said India's soldiers should “prepare for a decisive battle” against terrorism, and Pakistani officials did not rule out a nuclear response.

But India wanted to avoid war. It gambled that its coercive diplomacy and the risk of a nuclear war would compel the United States and Britain to force Pervez Musharraf, Pakistan's president, to withdraw support for the terrorists by ending infiltration into Indian Kashmir and dismantling terrorist camps near the frontier. The tactic worked, up to a point. Infiltration decreased, but India says it increased again at the end of June. It says Pakistan has not tried to close down the camps and end support for terrorists who are already inside Indian Kashmir. India is also sceptical about Pakistan's denial of responsibility for last weekend's killings.

So why has India's response to the killings been muted? Officials say they lack firm information about who was responsible. But there are other, bigger reasons. The government knows that it cannot expect international opinion to swing into action against Pakistan every time there is a terrorist attack, and that it will lose credibility if it repeatedly threatens a war that fails to materialise. There was yet another incident this week, when Indian security forces exchanged fire with suspected militants hiding in a mosque in Banihal.

The government wants to concentrate on state-assembly elections in Jammu & Kashmir planned for September or October, which, it hopes, will lower tensions. A relatively quiet period before the polls will, it is hoped, persuade Kashmir's sceptical political parties to take part, and a credible number of people to vote. Arun Jaitley, a former law minister, was appointed this week to start talks with political parties on giving the state more autonomy. The state government has begun to face up to allegations of human-rights abuses by security forces. It admitted this week that forensic tests have shown that five alleged foreign terrorists, who were killed by security forces two years ago after 35 Sikhs had been massacred, were innocent civilians. But sceptics in Kashmir said the announcement was an electioneering ploy.

There is a risk that Mr Musharraf will be tempted to allow infiltrators to cross into Indian Kashmir and stage occasional terrorist attacks, on the assumption that India will stay quiet. Bigger attacks could then be staged during and after the elections which, India assumes, Pakistan will want to disrupt.

This risk is expected to be discussed in talks that Jack Straw, Britain's foreign secretary, is due to have this weekend in Delhi and Islamabad, followed next week by Colin Powell, the American secretary of state. India's line is that it will not agree to talks with Pakistan until infiltration stops and terrorist camps are disbanded. It is sceptical about whether America and Britain are willing to deal firmly with Mr Musharraf while they need his support for tackling al-Qaeda's wider international terrorism. But, India will tell the visitors, it will only be persuaded that Mr Musharraf is trying to stop terrorism if the Jammu & Kashmir elections are relatively free of attacks. Don't expect peace in the subcontinent if the elections are disrupted.

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China

Don't call me a private eye

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Investigators stay under cover

YANG HAI, a former policeman, believes China's entry into the World Trade Organisation will do wonders for his private detective agency. More foreigners doing business with China will mean more demand for a host of services that China's law enforcement agencies usually will not provide, among them background checks on prospective business partners, and investigations of insurance claims and trademark theft.

But despite being a member of the World Association of Detectives (as a certificate displayed in his office declares), Mr Yang is anxious to avoid the use of the word “detective” in connection with his business. A government directive issued in 1993, though patchily enforced, bans any “private detective agency-like non-governmental organisation”. In China, only the state has the power to investigate criminal activity. Instead, Mr Yang runs what he cautiously calls an “investigation service” for foreign and Chinese businesses. Chinese who buy life insurance in America, then make fraudulent claims on their return to China, are among the targets of his inquiries.

Mr Yang's ten years as a policeman should have equipped him well to stay on the right side of China's often blurry laws. They certainly helped him get established nine years ago, when he took “sick leave” from the force and set up an investigation service under the wing of a Beijing law firm, which provided him with his first cases. A year later, his police supervisor, worried about Mr Yang's prolonged moonlighting, told him to return to work or resign. “You need a lot of resolve to quit a government job,” says Mr Yang. But the market beckoned. He resigned and set up the Steele Business Investigation Centre, with the help of two other ex-cops.

Mr Yang is one of the few in this fast expanding business in China willing to identify themselves publicly. His company even has its own website. Most others prefer to advertise in local newspapers, often targeting a useful potential clientele: women whose partners have been unfaithful. China's economic reforms have created a growing middle class, many of whose male members travel frequently on business. Their mobility gives them greater opportunities for affairs.

A new provision in China's marriage law adopted last year allows women to sue their husbands if an affair leads to their divorce. Advertisements abound for “lawyer's offices” specialising in “marital investigations”. The official Chinese media often portray these as shady operations. They may have a point. “I learn about the law on the job,” admits one investigator who handles marital cases. He describes himself as a private entrepreneur who, among other things, dabbled in petty smuggling before setting up his agency last year. He asked not to be named.

The industry received a boost in December when the Supreme People's Court ruled that legally obtained clandestine recordings made by private citizens would henceforth be admissible in court in civil cases. Legal experts believe this should apply to evidence gathered by private detectives by filming, photographing and recording their targets in public places or, with permission from a chief occupant, in private residences. “This has made room for the development of private detective agencies,” says He Jiahong, of People's University in Beijing, who estimates that several hundred such companies have been established over the past decade.

Foreign companies have also been making inroads into the Chinese market, offering investigations into copyright and trademark violations and due diligence checks. But they avoid registering themselves as private investigators, using instead such labels as “business research” or “consultants”. But the government turns a blind eye, aware of the necessity of giving foreign companies in China the means to protect their commercial interests. “It's not reasonable to put a complete stop to private investigations,” says Mr He. “The state can't take care of all these things.”

The state, as always, is fearful of ceding its jealously guarded privileges to ordinary citizens. Few expect the government to give explicit sanction to private investigators any time soon. To do so could empower citizens to find out more than the government wants them to know. Much commercial wrongdoing (and marital infidelity) involves government and Communist Party officials. In criminal cases, giving ordinary citizens the power to gather evidence would considerably weaken the party's sway over the country's legal apparatus. Mr Yang, running his “investigation service”, has strong advice to any Chinese gumshoe who dares call himself a private detective: it would delay official recognition of the business for years.

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East Timor

Dili-dallying over language

Jul 18th 2002
From The Economist print edition

The problem of choice

Get article background

CREATING the world's 192nd state is tough when you are facing an unemployment rate of 70%, an illiteracy rate of 43%, and an average daily income equivalent to 55 cents. Complicating matters further is a heated debate over language. After four centuries of Portuguese rule, 24 years of Indonesian occupation, and two years of United Nations' administration, East Timor gained independence in May. The new constitution designates Tetum (the indigenous *lingua franca*) and Portuguese as official languages, and English and Indonesian Bahasa as working languages. Yet many question the viability of Tetum, the wisdom of promoting Portuguese at the expense of English, and the future of Indonesian Bahasa.

Why should Portuguese be retained, given that barely a quarter of the population speaks it? Its use by the leaders of the independence struggle gives it symbolic value as a language of resistance. Xanana Gusmao, a former guerrilla leader and now president, deems Portuguese vital to East Timor's culture, a hybrid of indigenous and Portuguese elements. Retaining Portuguese also sets the country apart from its domineering neighbours, Indonesia and Australia.

Geoffrey Hull, the Australian-based author of the first English-Tetum dictionary, further argues that Portuguese is the world's sixth most widely spoken language and should help the emerging tourism industry. Partly on the basis of its Latinate architecture in Dili and elsewhere, the country hopes to sell itself as a slice of the Mediterranean in South-East Asia. Portuguese-speakers can pick up French, Italian and Spanish, important languages in tourism. Portuguese is not very different from Tetum in terms of its sounds, grammar and vocabulary, so it should be relatively easy for the Timorese to learn, and it is being introduced into primary schools. Yet the young may prefer to learn English.

The future of Tetum is similarly unclear. As the language of the royal rulers in the 16th century, Tetum became dominant on the island. Following Indonesia's invasion in 1975 Tetum became a language of resistance. Its survival was aided by the Roman Catholic church's decision in 1981 to adopt it as the language of ritual, in place of Portuguese. Yet Tetum's written form remains incomplete and there is a shortage of published materials.

Portuguese and Tetum are also challenged by the use of English and Bahasa as languages of trade. While Bahasa is being officially phased out, Indonesia remains East Timor's largest trading partner. The unofficial status of English is not expected to prevent its spread, but it is feared as a notorious killer of indigenous languages and cultures.

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Iranian politics

Time for all good reformists to resign

Jul 18th 2002 | TEHRAN
From The Economist print edition

AP

Ayatollah Taheri (in the foreground) says the unsayable

Get article background

"IMAGINE a game of chess after the board has been overturned, and no one is sure where to put the pieces." Thus an analyst describes Iranian politics in the wake of Ayatollah Jalaluddin Taheri's sensational open letter on July 10th. Before this public lambasting of Iran's strangely counter-productive way of running itself, the struggle between reformists and conservatives had become a stalemate, almost putting Iranians to sleep. Now, even if the chessmen go back more or less to where they were before, the spectators have woken up—and the play may be bolder.

Mr Taheri, a reformist cleric, delivered his criticism with considerable lyrical power. His feat was to say what no one of consequence has dared to say since the cleric-politicians led by Ayatollah Ruhollah Khomeini consolidated their power after the 1979 Islamic revolution.

From his base in Isfahan, Mr Taheri debunked those who climb to office "on the ladder of popular sanctities and beliefs," as well as the "fascist" thugs under their command. He mocked "our betters", who "compete with one another to steal the capital and wealth of the nation." He attacked the powers of veto that have been assumed by conservative-run institutions (and which hold up political reforms longed for by the majority). For good measure, the ayatollah announced that he was resigning as Isfahan's Friday prayer leader.

His letter was addressed to all Iranians. Nonetheless, the conservative-minded supreme leader replied to it on July 12th. Ayatollah Ali Khamenei assured Mr Taheri that he shared some of his concerns—though not, it would seem, his urging that the highest office-holders be regularly rotated, or that the regime be subjected, for its own good, to invigorating criticism. "Efforts to weaken the edifice of the system", said the supreme leader darkly, would not be forgiven.

Mr Taheri listened. On July 17th, to the disappointment of many of his supporters, he bowed to conservative pressure and put his signature to an "interview" in which he charitably described the supreme leader as a "comrade" of reform.

Yet his original critique cannot be unsaid. Conservatives hope to prevent the errant ayatollah from being turned into a second Hossein-Ali Montazeri, a senior cleric whose long period under house arrest has won

him much sympathy from dissidents inside and outside Iran. Mr Montazeri was pushed from office, when he refused to be disciplined. Mr Taheri's withdrawal from public life was voluntary.

Should others also resign? In the run-up to his resounding re-election victory last year, the reformist president, Muhammad Khatami, let it be known that he was considering resigning in protest at conservative obstructionism. The day after the publication of Mr Taheri's letter, Abbas Abdi, who is known as a “radical” reformist, elliptically challenged Mr Khatami to make good on his threat.

More and more Iranians are said to be coming round to Mr Abdi's belief that the only way to bring real pressure to bear on the conservatives is for frustrated reformists to quit public life. Convinced that its deputies will be disqualified from standing in the 2004 parliamentary election, the biggest reformist party is considering boycotting the polls. If voters do the same, the regime would lose the popular legitimacy the conservatives still ascribe to it.

Mr Khatami is no longer an inspiration. He has been forced on to the defensive, not least by the crisis in foreign affairs brought about when George Bush included Iran in his “axis of evil”. Then, on July 12th, Mr Bush again contrasted Iran's unelected rulers to its reform-minded citizens. Conservatives delightedly insinuated that Mr Khatami and his allies were in America's pocket, and Mr Khatami was moved to recall nostalgically the Clinton presidency, when officials kept their comments about Iran's internal politics to a minimum.

A mountain of ice and snow

The momentum that twice brought Mr Khatami to power has slowed. This became obvious at recent demonstrations to commemorate the large-scale student protest that took place three years ago. Although some protests were held, the protesters were in many cases outnumbered by the police, and by hired toughs who responded to slogans with baton-blows. Mr Abdi has likened popular enthusiasm for reformist politics to a “mountain of ice and snow, melting continuously.” If they want to preserve what remains of it, reformist leaders may have to emulate Mr Taheri.

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Middle East endgame

A way of winning

Jul 18th 2002
From The Economist print edition

With a solution proposed by the International Crisis Group

Get article background

PEOPLE of goodwill are by now generally agreed on what the elements of a Middle Eastern peace should be: the crippling difficulty is how to get from here to there. The International Crisis Group (ICG), a body that produces well-informed analyses of world conflicts, suggests that the main outside players—the American, Russian, EU and UN"quartet", plus the Egyptian, Jordanian and Saudi "trio"—should lay a detailed plan for a permanent Arab-Israeli settlement on the table, and then dedicate themselves to ensuring that their ideas are implemented.

While it would be impossible, the ICG argues, to impose any solution on the countries directly concerned, the intensity of sustained pressure, plus the promise of international money, monitors and policemen, might generate an irresistible popular momentum for peace. This, or so it is hoped, could sweep leaders who are ill-disposed towards a settlement into inconsequence.

The ICG has produced its own impressive blueprints for both an Israeli-Palestinian agreement, and Israeli-Syrian-Lebanese peace treaties. The Syrian track is crucial, the group argues, if there is to be Arab support for a Palestinian solution, and full Arab peace with Israel.

The group's ideas for a future Palestine are based, with variations, on the themes that emerged in 2000-01, after the collapse of the Camp David talks. They include Israel annexing up to 4% of the West Bank in exchange for an equivalent chunk of Israel. But Jerusalem, except for the Old City, would not be an open city: it would be the divided capital of both states, with Jewish bits of East Jerusalem going to Israel, and Arab ones to Palestine. The refugees would be offered resettlement or compensation, but not the right of return.

For its success, the ICG's plan relies on the depth and comprehensiveness of multinational support—and presence. International involvement, it argues, has to be American-led, including the military force that would serve both to assuage Israeli fears about the character of a Palestinian state, and Palestinian fears that Israel would not implement an accord.

But how to acquire that degree and direction of American leadership? At present, the American administration, bowing to the Israeli government's wishes, is concentrating solely on demanding a change of Palestinian leadership. Yet, in the current vacuum, the only new leaders the Palestinians are likely to choose are more opposed to compromise than the ones they already have. The ICG report deals tactfully with George Bush's Middle East policy. But the horrors will continue, it implies, until the Americans are persuaded that their chosen way out is a cul-de-sac.

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Jordan and Iraq

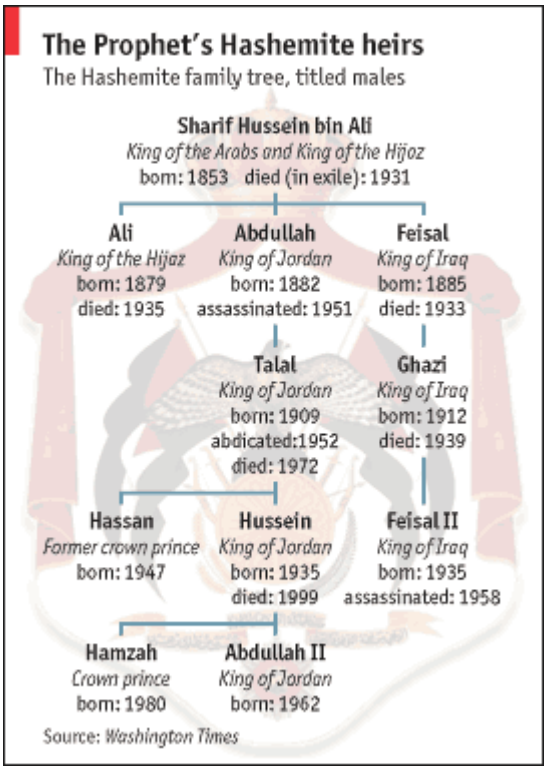
A king for Iraq?

Jul 18th 2002 | AMMAN
From The Economist print edition

The nostalgic, perhaps ambitious, Hashemites

ONE of the more lively moments at last week's get-together of a group of Iraqi dissidents was when Prince Hassan, Jordan's elder statesman, strode into their London meeting-place. He then embraced a scion of King Feisal, his murdered cousin and the last king of Iraq. In conversation, Jordan's Hashemite prince spoke of “assuming his ancestral responsibilities” in the region, harking back to the first world war, when his great-grandfather was the British-appointed king of the Arabs, and his great-uncle the king of Iraq.

A waft of Hashemite nostalgia was in the air. Courtiers reminded people that Spain, after Franco, brought back the Bourbons to hold together another post-dictatorship seething with separatist tendencies. Nor was it lost on anyone that the rebels held their conference on the anniversary of the downfall of the Iraqi monarchy on July 14th 1958.



Mischievous onlookers suggested that Prince Hassan has been searching for a throne ever since his elder brother, King Hussein, dumped him as his successor a month before he died. After three years in the political wilderness, Prince Hassan seemed to revel in the media spotlight. But he is not an Iraqi. And the Iraqis, battered by outsiders for over a decade, are fiercely nationalistic, even in opposition.

Jordan nervously awaits an Iraqi response. For the past week, Jordanian ministers have been tirelessly denying media reports that the kingdom is in cahoots with America and the Iraqi opposition to topple Saddam Hussein. Now Prince Hassan seems to have given his open blessing to a militant branch of the opposition that favours all means of bringing the regime down, including an American strike.

The prince insists that he was at the meeting in a personal capacity. Conspiracy theorists wonder if, for all Jordan's naysayers, King Abdullah and Prince Hassan are playing a game of good cop, bad cop as they scheme to exploit the political vacuum looming over Iraq. The rose-tinted old guard in Jordan still hanker after the brief Hashemite union in 1958, when King Hussein ruled Jordan and his cousin ruled Iraq, and both aspired to Kuwait.

But this theory has serious flaws. King Abdullah belongs to a younger generation of Arab rulers who believes it is success enough to hold on to one's own throne, let alone grab anyone else's. Moreover, the king and the prince do not get along. Prince Hassan still believes he would make a better monarch than his nephew. He may even enjoy stirring the Iraqi pot in the hope of upsetting the king.

But this is a dangerous game. Iraq's potential for trouble-making in Jordan is considerable. This week, the Iraqi press agency reported that the Iraqi ambassador to Amman had received a pledge of allegiance from the chieftain of Jordan's powerful Beni Hassan tribe. And so fearful are Jordanians that Iraq might plug their supply of oil, that the state-owned news agency, Petra, took the unprecedented step of publicly disowning the former crown prince's Iraqi debut.

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Jordan and the Palestinians

Stuck on the bridge

Jul 18th 2002 | JERICHO
From The Economist print edition

The Palestinians' last exit is closing too

AP

Stranded

FOR the past month, hundreds of Palestinians have been sleeping rough beside Allenby bridge near Jericho, the last remaining exit and entry point for West Bankers. The blockage is caused, says the Palestinian Authority (PA), by new Jordanian border controls that have reduced the number of Palestinians crossing the bridge on any one day from 1,000 to only 150.

Jordanian officials fear that the frustrated travellers could be the first trickle in a flood of refugees born of Israel's re-occupation of the West Bank. The government's alarm, fuelled by newspaper stories that 70,000 Palestinians have illegally set up home in Jordan since the start of the *intifada* in September 2000, is understandable. Three times in the past 50 years, Jordan has been inundated with Palestinians fleeing war. The refugees were treated generously, given citizenship, and are now a majority in the kingdom.

The PA says that, on the contrary, the number of Palestinians trying to cross the bridge is lower than average. Israel's re-conquest has made it much harder (and much more expensive) for them to travel. Moreover, many of the people stuck in Jericho are not bound for Jordan, but for Europe and America. Since January, Israel has stopped Palestinians from travelling through its airports, so their only way out is to go to Amman airport instead.

The PA's pleas have had little effect. Last week Jordan announced tough new rules for Palestinians entering the kingdom. Apart from “humanitarian” cases, they must now show an invitation approved by Jordan's interior ministry, and bank statements with deposits of at least 2,000 Jordanian dinars ($2,800): an enormous amount for Palestinians in these harsh times.

Jordanian spokesmen say the measures are intended to steel Palestinian “steadfastness” in the struggle against Israel's occupation. But Palestinians say it is yet another wall in a land that is already a maze of walls.

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Botswana's nomads

No more hunting and gathering

Jul 18th 2002 | NEW XADE
From The Economist print edition

Modern Africa leaves no space for nomads

“WHERE I lived before, I killed animals and ate the meat. When the rain fell I got wild fruits. But I didn't have enough water. The government asked me to move here.” Nyatsang Dira, a man in his 70s, stands under the glaring sun in dusty New Xade, a newly-created village on the edge of Botswana's Kalahari desert. He is one of some 2,000 Basarwa, or San Bushmen, evicted by the government from the parched Central Kalahari Game Reserve since 1997. Just a few dozen, mostly old men, remain in the reserve. One of Africa's last nomadic cultures is about to be snuffed out.

Botswana's president, Festus Mogae, says that “hunting and gathering is no longer a viable way of life.” In New Xade the government provides a school, a hostel for children whose parents work on farms far away, financial compensation, boreholes for water, a new road, cattle, sheep and welfare payments. It is the sort of official attention that few Africans enjoy.

But a walk around the settlement shows that many Basarwa find modern life difficult. Alcoholism seems rife; one of the village's four policemen says assaults and drunkenness are common. To deter rising crime, goat thieves are now jailed for five years. And the worst thing about New Xade? Said one villager, there are no wild fruits.

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Zambian politics

Biting the hand

Jul 18th 2002
From The Economist print edition

Turning on his patron

TO THE surprise of many, Zambia's parliament voted unanimously on July 16th to strip Frederick Chiluba of immunity from prosecution, so he can face charges of corruption that relate to his decade as president. Mr Chiluba, who denies being a crook, won a respite the next day, when a judge halted the investigation pending a ruling as to whether parliament had acted legally. If Mr Chiluba is eventually hauled into the dock, few will shed tears. His government was pretty venal. Ministers profited from the sale of state assets, and millions of dollars mysteriously disappeared. Yet prosecution of the ex-president had seemed unlikely. His hand-picked protégé, Levy Mwanawasa, narrowly won the election last December, beating candidates who had promised to hold Mr Chiluba to account.

But President Mwanawasa has turned on his predecessor, and on others, in a campaign supposedly aimed at cleaning up politics. Last week he recalled parliament early to demand that Mr Chiluba lose his immunity. At the same time the foreign minister and chief justice were forced to resign, accused of taking illicit payments, and the ambassador to the United States was arrested in Lusaka.

Why has Mr Mwanawasa chosen to bite now? No doubt he wants to please foreign donors, who pay many of the government's bills, by demonstrating his intolerance of graft. And he may well gain popularity by proving he is not Mr Chiluba's stooge. According to Anderson Mazoka, the opposition leader, the ex-president's “plunder was seen as the number-one contributor to suffering in this country.” This week, hundreds of protesters gathered outside parliament to demand that Mr Chiluba stand trial.

But the main reason may be that Mr Mwanawasa needs to distract attention from the suspicious way he won the election with only 29% of the vote and a margin of just 33,000. Observers called the poll “unsafe”. Mr Mazoka says it was rigged. On July 22nd the Supreme Court is to consider his petition to have the result overturned. The president says he isn't scared. His job gives him a lot of power: Mr Chiluba was able to have his own predecessor, Kenneth Kaunda, jailed for a while on fishy charges. Mr Mwanawasa may turn out to be equally harsh. Four journalists were recently arrested for suggesting he might have a brain disease.

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Europe's convention

The tortoise is thinking of moving

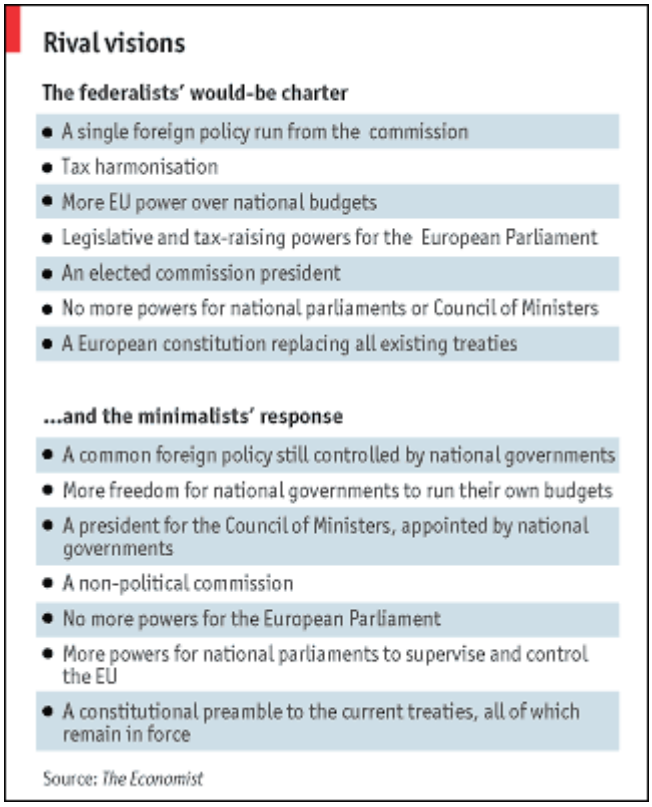
Jul 18th 2002 | BRUSSELS
From The Economist print edition

Europe's constitutional convention gets down to business but its wily chairman won't force the pace

Get article background

RATHER theatrically, Valéry Giscard d'Estaing, chairman of the European Union's constitutional convention, has placed a large green ceramic tortoise next to him on the raised dais from where he surveys the proceedings. Wou Kei, as Mr Giscard d'Estaing explains, is a Chinese antique. It embodies longevity, thinks long-term and achieves its aims at its own pace. All the characteristics, in short, that the convention's 76-year-old chairman claims for himself.

Almost half a century after the first six members of what became the European Union dedicated themselves to “ever closer union”, the club is trying to write a constitutional treaty to see it through the next 50 years. But why now? Because the EU is about to expand to take in ten new members; because Europe's newly-minted single currency may demand further political and economic integration; because there is growing frustration in Brussels at the EU's failure to be a more effective actor on the world stage; because the Union realises it is not very popular and wants to do something about it; and, to be frank, because the most ardent advocates of turning it into something like a federal state see a golden opportunity for pressing their case.



Some of the convention's keenest federalists are frustrated by Mr Giscard d'Estaing's ostentatious refusal to be hurried. From the floor last week Olivier Duhamel, a French Socialist, complained that the convention's ordinary members “have been left dangling in the wind”. He demanded to know “what is really going on behind closed doors”, reflecting a widespread suspicion that the convention's wily chairman intends to let the delegates talk themselves out before presenting his own pre-cooked constitutional draft.

Not at all, replies Mr Giscard d'Estaing. It was important, he says, that the convention should start with a “listening phase” of a few months. This, he says, is over. In the second stage, ten working groups will ponder particular aspects of the convention's work, such as the role of national parliaments and European foreign policy. Finally, there will be a crunch. The conventioneers will battle it out over an actual text; some time around next May, they expect to propose a constitution for Europe.

The control of foreign and economic policy is central to the debate. Keen federalists, well to the fore in the convention, want a single European foreign policy. In their ideal world, it would be formulated by the European Commission in Brussels and decided on by a majority vote of the EU's countries. Peter Glotz, the German government's man at the convention, says that national foreign ministries should be phased out in favour of an EU diplomatic service. Jean-Luc Dehaene, a Belgian who is one of the convention's two vice-presidents, has proposed a European foreign minister. Only through devices such as these, argue the federalists, can the EU truly aspire to be a world power.

Peter Hain, the British representative, pleaded at the convention for members to “be realistic”; any EU foreign policy, he insisted, must continue to be agreed upon by sovereign states. His was a fairly isolated voice but Britain thinks that at least France and Spain will concur. Importantly, Mr Giscard d'Estaing also seems “intergovernmental” in foreign policy, meaning that governments should have the final say.

With the creation of the euro currency, now used by 12 of the EU's 15 members, economic policy has also taken on a new urgency. Under their single European monetary policy, euro-zone countries have already agreed to limit their budget deficits and to respect broad guidelines in making economic policy. But what more is required? The working group considering these questions is asking itself whether the EU needs further tax harmonisation and whether the commission should be given greater powers to force governments into line over their budgets.

These debates over policy are inseparable from the turf wars between the European institutions and between the various governments. Behind arid-sounding questions about institutional architecture lurk huge ones about the balance of power between individual countries and between the EU and the countries that belong to it.

Federalists favour what they call the “community method”, which in fact would shift more power to the Brussels institutions (in essence, the European Commission and the European Parliament) and make European countries decide more issues by majority vote. They argue that letting national governments retain their current powers, including a wide capacity for vetoing legislation they dislike, in an EU of 25 countries is a recipe for paralysis.

Love me, do

They also claim that the answer to public disillusionment with the Union (the “disconnect”, in Brussels jargon) is to democratise it by giving it an elected president and handing more powers to the European Parliament. This week Romano Prodi, the European Commission's head, said the EU should have a single president for both the commission and the Council of Ministers, which is where national governments now haggle over European legislation. He also suggested giving the European Parliament tax-raising powers.

The intergovernmentalists scoff at this notion that the European Parliament is answer to the EU's perceived lack of legitimacy. They point to the paltry turnout at European elections and suggest that aiming for a European democracy without the existence of a European “demos”—an electorate and a citizenry that feel loyal to the European Union—is asking for trouble. They reckon that involving national parliaments more closely in the workings of the EU is the way to address the disconnect.

With that aim in mind, the British suggested a second chamber of the European Parliament made up of members of national parliaments, but that idea has failed to fly. Mr Giscard's people are working on another idea: to give national parliaments the job of policing the powers of the Union by ensuring that all proposed EU legislation should be referred first to national parliaments, which might block the legislation at the outset if they could show that the EU was exceeding its powers.

Davids and Goliaths

Many of these arguments are breaking down into disputes between big and small states within the European Union. The small countries tend to be keener on integration. They fear that a looser, more inter-governmental EU would be run by the bigs and that their own voices would be ignored. The bigger countries, with the notable exception of Germany, are suspicious of giving more power to the commission and the parliament. They dispute the notion that the Brussels institutions are always impartial arbiters of Europe's common interests, pointing out that they have their own interest in grabbing more power for themselves. The bigs also point out that of the EU's original six countries, three were big and three small; in an enlarged Union 19 will be small, six big (Germany, France, Britain, Italy, Poland and Spain); European voting procedures are weighted to give the smalls extra clout.

And where does Mr Giscard d'Estaing stand on all this? He argues, reasonably enough, that the Union will always remain a hybrid, partly run by the community method and partly in an intergovernmental way. Indeed, he suggests that Article 1 of any new constitutional treaty will start with this point.

But the federalists fear that the convention's president, hailing as he does from France, is veering towards the constitutional model favoured by the bigs, with an emphasis on clarifying the current powers of the Union rather than on taking grand strides towards “ever closer union”.

Mr Giscard d'Estaing's people shy away from so blunt a characterisation of their intentions. But they say it will be pointless for the convention to present a dramatic constitutional blueprint if it cannot then command the unanimous approval of the EU's governments, as any new treaty must. If Mr Giscard d'Estaing's draft disappoints the convention's many federalists, he will have a big fight on his hands. The convention may indeed break up in acrimony, perhaps without agreeing upon a single proposal. As a gentle warning, Mr Giscard d'Estaing points out that his tortoise mascot has a dragon's head and, if called upon, can breathe fire through its nostrils.

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France's president

Lucky, canny Jacques

Jul 18th 2002 | TOULOUSE
From The Economist print edition

Does France's president, politically and literally, have a new lease of life?

Get article background

Reuters

An assassin's target

HE HAD quite a week. At the start President Jacques Chirac survived an assassination attempt by a far-right extremist; at the end he went off to Russia; in between he grappled with the Danish prime minister, the German challenger for the post of chancellor, the Saudi foreign minister, the Czech president, the governor of the Bank of France and the secretary-general of the organisation dedicated to keeping the French language global. Not to mention a quick trip to Toulouse to inaugurate an enormous assembly site for the Airbus A380, the world's biggest airliner.

What does it all add up to? In a television age, the president's sangfroid after the amateurish attempt on his life was impressive enough; though the gunman in the middle of a crowd and with only a .22 rifle, had little chance of hitting Mr Chirac as he took part in the military parade marking Bastille Day. The list of appointments was serious enough too: Denmark has just assumed the European Union's presidency; Edmund Stoiber, if he becomes Germany's chancellor in September, might take a kinder view of France's addiction to the EU's farm subsidies; Saudi Arabia is a player in the Middle East, where France claims a role; and the Bank of France's Jean-Claude Trichet, assuming he escapes his judicial embarrassment (see article), is still hoping to become the next boss of the European Central Bank.

But the biggest fresh impression is of a man of action. Liberated, thanks to this spring's elections, from five years of impotent “cohabitation” with the left-wing government of Lionel Jospin, the centre-right Mr Chirac now has a five-year presidency with a government of his own choosing. His new message is that he wants to push that government, headed by Jean-Pierre Raffarin, to its limits.

Hence Mr Chirac's insistence, in his Bastille Day television interview, that lowering France's taxes and payroll charges “at least” to the EU average is a matter of economic “survival”; that defence spending and military efficiency must go up (“for a while now, we have fallen behind Britain”); that the handicapped must be better provided for; that cancer rates must be cut; and that France's death rate on the roads (more than double Britain's) must be reduced too.

The question is whether the government really is being asked to go beyond its limits—especially if, as seems likely, economic growth fails to reach the assumed annual rate of 3%. Last week the finance minister, Francis Mer, disparaged a call by the social-affairs minister, François Fillon, for government intervention when firms declare redundancies—only to find that this week Mr Chirac was agreeing with Mr Fillon that there should be a “structure” to let government “intervene massively”. Perhaps the president, knowing that a robustly reformist approach helped fell the last conservative government, is cannily playing a populist card to bolster Mr Raffarin and his colleagues. The other view, of course, is that the president is already leaving the government in the lurch.

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Italy, its prime minister and the law

He's sitting pretty

Jul 18th 2002 | ROME
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Silvio Berlusconi is now nearly beyond the reach of his country's courts

The trials and tribulations of Silvio Berlusconi

Case	Business	Charge	Verdict	First appeal	Final appeal
All Iberian	Offshore company	Illegal financing of political party	Guilty	Granted by statute of limitation*	Same as first
Fininvest and others	Holding company	Four counts of corruption; bribing financial police	Guilty	Granted by statute of limitation on three counts*; acquitted on one	Acquitted on all counts
Medusa	Films	False accounting	Guilty	Acquitted	Same as first
Villa Macherio	Real estate	Tax fraud	Statute of limitation*	Covered by amnesty	
Fininvest	Holding company	False accounting	Acquittal or statute of limitation†		
Mondadori	Publishing	Corruption; bribing a judge	Case thrown out‡		Statute of limitation*
Purchase of player	AC Milan football club	False accounting	Acquittal or statute of limitation†		
SME	Food	Corruption; bribing judges	In process		
Fininvest Group	Holding company	False accounting	No charges brought†		

*Under the Italian penal code, the statute of limitation extinguishes the crime
†Because of new legislation ‡Preliminary hearing

Source: *The Economist*

WHEN he became Italy's prime minister a year ago, Silvio Berlusconi faced four criminal trials. Now just one charge, that of bribing judges, remains. Mr Berlusconi is very likely to be acquitted in three false-accounting cases against his companies because new legislation brought in by his government has put most types of false accounting by private companies into the civil rather than criminal category of misdemeanours (see our table). In any event, the cases would probably be set aside under a statute of limitation; other bills before parliament are likely to ensure that the remaining case against Mr Berlusconi could drag on for years. And even if the verdict in that case eventually went against him, it is by no means certain that the public, apparently bored by the long-running saga of court cases involving their prime minister, would care.

Moreover, Mr Berlusconi has happily avoided other legal entanglements that might have embarrassed him. It now looks unlikely that he will be questioned in court about his business past in two criminal trials of close colleagues, one of whom is accused of association with the Mafia. The judges, it seems, will accept that, as foreign minister as well as head of the government, he would quite simply be too busy to attend.

That has particularly disappointed prosecutors in Palermo, the capital of Sicily, who have waited patiently for Mr Berlusconi to testify in the trial of a close friend of his, Marcello Dell'Utri, a senator who has been charged with aiding and abetting the Mafia. The judges had ruled that at a special hearing on July 11th Mr Berlusconi was to have given detailed responses to questions that he had hitherto refused to answer at all fully. Among other things, he would have been asked why he had employed Vittorio Mangano, a known *mafioso*, on his country estate near Milan. He would also have been asked where the 22 holding companies that Mr Berlusconi set up in the 1970s and through which he owned his Fininvest group got their original funds.

Mr Berlusconi's spokesman explains that he could not, after all, attend last week's hearing in Rome mainly because of a visit to Italy by King Juan Carlos of Spain. A diplomat at the Spanish embassy says

that the king, who was on a private visit, met Mr Berlusconi at 7.30pm on the day of the hearing. Mr Berlusconi's lawyer has suggested two dates when he could appear at a new hearing in October.

This week the same thing happened. Mr Berlusconi was due to testify on July 15th on behalf of Vittorio Metta in a trial in Milan over bribing judges. Mr Berlusconi's spokesman explained that he could not after all be there as he had to lay the first stone for a high-speed train-bridge and then meet the Bulgarian foreign minister. Mr Berlusconi is alleged to have bribed Mr Metta, an appeal-court judge, to rule in his favour in a bitter takeover battle for Mondadori, a publishing group, in 1991. The charges against Mr Berlusconi were quashed on the eve of last year's general election under a statute of limitation.

Giving evidence on behalf of Mr Metta would have exposed Italy's richest man to a testing cross-examination by prosecutors. Mr Berlusconi, however, said that he would exercise his right to silence if summoned again. He has this right because he is himself a defendant in the related SME case in Milan, which is also to do with allegations of bribing a judge.

Controversy has dogged this trial too. New legislation passed by Mr Berlusconi's government in October was used to challenge the admissibility of the prosecution's evidence, but the judges were unmoved. In January the justice minister, invoking procedural law, nearly stymied the SME trial altogether. Members of the government have continued to lambast the Milanese magistrates, whom Mr Berlusconi has persistently accused of left-wing bias against him.

In March he made a new suggestion. He asked a court to move the SME trial to Brescia, east of Milan. If that happened, it would have to start again. Mr Berlusconi said he could not get a fair trial in Milan. Since the reform of Italy's penal code in 1989, trials have been transferred very rarely to new jurisdictions, because the circumstances in which that can happen are narrowly defined, partly to prevent defendants from shopping around for favourable judges.

But the final appeals court supported an argument put forward by Mr Berlusconi's lawyers that there may be a constitutional flaw in the reformed penal code. It referred the matter to the constitutional court, which may yet decide, when it gives its opinion in the autumn, that the SME trial should be started anew—and in another place. Meanwhile, it has been rumbling along in Milan. But, in yet another legal twist, it could be stopped before the court makes its decision, if another bill recently brought in by a pro-Berlusconi MP is enacted. This bill says that a trial must be suspended until an application to move it to another place is decided.

If the SME trial did ever run its course and the verdict went against Mr Berlusconi before a statute of limitation applied, there might be a final safety net for him. Yet another bill introduced by a senator in his coalition would make judges take “extenuating circumstances” into account when crimes are committed by anyone over 65 or by anyone without a prior conviction. This means that a statute of limitation could apply earlier in the SME case. Mr Berlusconi is 65.

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Spain, Morocco and Gibraltar

A row over rocks

Jul 18th 2002 | MADRID
From The Economist print edition

If you want Gibraltar, says Morocco to Spain, why can't we have some rocks?

IT SEEMED, at first glance, to be the stuff of farce. Morocco lands some soldiers on a tiny, uninhabited island near Ceuta, one of Spain's two north African city-enclaves. Spain grabs it back. The Moroccans think the Spaniards are being hypocritical in wanting Britain to hand over Gibraltar while refusing to talk to them about the Spanish bits of land just across the water. Morocco's dramatic action has certainly put its complaint before the world forum. Mindful of the rising importance of pro-western Muslim countries since last September, the world has duly taken note. The United Nations may now get involved. While half-heartedly backing Spain, the EU has duly wrung its hands.

It was on July 11th that a group of Moroccan gendarmes occupied the islet, empty bar a herd of goats that feed on the wild parsley from which it takes its Spanish name, Perejil. Moroccan marines then took over from the gendarmes. Spain's prime minister, Jose Maria Aznar, refused to accept this, and sent five warships and a submarine, plus helicopters and other aircraft, to the area. The 7,000 men of Spain's Foreign Legion, who defend Spain's two north African enclaves, Ceuta and Melilla, were told to be ready to fight. At dawn on July 17th Spanish commandos recaptured the island and put a Foreign Legion unit ashore to hold it, without a shot fired. The captured Moroccans, unharmed, were set free at Ceuta's border with Morocco.

But this is not the end of the story. The island's status is unclear. Ceuta and Melilla, as well as two other rocky outcrops and a few small islands, are mentioned in various treaties between Spain and Morocco. Perejil (Leila to the Moroccans) is not. Spain insists that it does not intend to keep troops on Perejil, and its new foreign minister, Ana Palacio, says that dialogue is the way forward. But Morocco retorts that Spain scuppered an American-sponsored deal under which the Moroccans could have left the tiny island “voluntarily”, and has asked the United Nations to force a Spanish withdrawal. Morocco's foreign minister, Mohammed Benaissa, says Spain has committed an act of aggression. Moroccan troops have been moved from the Sahara to areas near Ceuta and Melilla.

How did it happen? Morocco's landing coincided with the King Mohammed's wedding celebrations. Mere exuberance, however, can hardly be the answer. The Moroccan foreign minister curiously claims that the landing was part of the fight against illegal immigration and drug smuggling into Europe; Spain has accused Morocco of turning a blind eye to both. It had nothing, he said, to do with negotiations between Britain and Spain over the future of Gibraltar.

But this, too, is a bit thin. The Moroccans, who think that Ceuta and Melilla ought to be theirs, naturally raise an eyebrow when Spain tries to prise Gibraltar away from Britain, whose foreign secretary, Jack Straw, said last week that negotiations about the Rock that lies opposite Ceuta would continue after the summer. And the Moroccans are understandably unimpressed by Spain's objection that Melilla and Ceuta are in no way comparable with Gibraltar because the one became Spanish in 1497, the other in 1580, before Morocco was even a state, whereas Gibraltar has been British for a mere 290 years.

Morocco also sees a contradiction between Spain's refusal to accept a referendum of Gibraltar's citizens about their future, while at the same time insisting on a referendum in the former Spanish Sahara. The people of that territory do not wish to become a self-governing region of Morocco, any more than Gibraltarians want to become part of Spain. Ah, but we are democrats and can be trusted, say Spaniards sniffily; Moroccans aren't and can't. The UN's Security Council is discussing the matter later this month.

Last October, Morocco withdrew its ambassador to Spain after rows about this, as well as over fishing rights and immigration; now Spain has pulled its ambassador out of Morocco. Nobody wants the latest spat to get nastier. But when two prickly nationalisms are aroused, beware.

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Charlemagne

Could Lothar Späth mend Germany?

Jul 18th 2002
From The Economist print edition

Both main parties need a dynamo to drive economic reform

"I'D BE off my head if I went back to that circus!", Lothar Späth once declared with his usual bluntness when asked if he might ever return to politics. Yet now, 11 years after resigning as premier of Baden-Württemberg, one of federal Germany's richest states, he has been lured back with the promise of a new "superministry" to run the country's economic and employment policy, with a special brief for reviving Germany's former communist east. That is, if the conservatives win September's general election. Edmund Stoiber, the conservative challenger for the chancellor's job, says Mr Späth is quite simply "the best". He would "put the nail in the Social Democrats' coffin".

Mr Späth's agreement to join the conservatives' "team of experts" on the campaign trail was certainly a coup for Mr Stoiber. His name is a byword for economic dynamism and entrepreneurial flair. He is famous for turning Jenoptik, a clapped-out East German optical-engineering company, into something very rare: an eastern success. Mr Stoiber wants Germans to believe that his new economics guru can do for Germany what he did for Jenoptik. Last week, the pair proudly presented a grand plan to spend *euro*10 billion ($10 billion) to create hundreds of thousands of jobs and get Germany growing again. "Offensive 2002", as it is dubbed, is the conservatives' answer to the bold labour-market reforms recently proposed by a government-appointed commission chaired by Volkswagen's Peter Hartz.

Small, bouncy, 64-year-old Mr Späth has immediately shot to second place in the political popularity charts, ahead of both Mr Stoiber and Chancellor Gerhard Schröder, and only just behind the eternal favourite, Joschka Fischer, the Green foreign minister. Mr Späth is not only regarded as a *Macher*, a man who gets things done, but also as a reformer fizzing with novel ideas. He has written or co-authored more than a dozen books with titles like "Can the Germans still be saved?" and "What must now be done". Until recently he hosted a lively talk-show on television. Now he may have a chance to put his ideas into action.

After leaving school at 15 with virtually no qualifications, this working-class lad with a strong Swabian accent, which he still has, raced up the Christian Democrats' ladder. He became mayor of Bietigheim, a town of some 30,000 inhabitants, by the age of 30. At 40 he was Germany's youngest state premier. Over the next 13 years, he turned his sleepy southern state into one of the wealthiest and most go-ahead high-tech economies in Germany. Autocratic and often abrasive, he was attacked by the then chancellor, Helmut Kohl, a fellow Christian Democrat, for running the state of 9m people as a one-man business. But in Baden-Württemberg, where his native peasant cunning earned him the nickname *das Cleverle*, he was much admired and liked.

Yet by the early 1990s, his career seemed in ruins. Involved in a failed effort to oust Mr Kohl in 1989, he was thrown off his party's national executive committee. Two years later he resigned as state premier after being accused of accepting exotic foreign holidays and other favours from industrialists. He repaired in disgrace to Jena, in the eastern state of Thuringia, where he took over the moribund Jenoptik from the Treuhand, the outfit charged with managing East Germany's state property.

Maybe he did turn the firm round, his critics sourly admit, but only after taking a state hand-out worth nearly $2 billion and axing 16,000 jobs. Only 1,100 of Jenoptik's present 7,000 employees are now even based in the east, the carpers point out; the rest live in western Germany or abroad, so the eastern state, it can be argued, barely benefited. Nor, they note, is the company' success undiluted. Profits nearly tripled in 2000 but rose by only 2% last year and the firm made a loss in the first quarter of this one. Mr Späth is unshaken. Others got equally big public hand-outs, he replies, but still failed dismally. Moreover, Jenoptik's success has helped to create lots of other jobs by attracting a cluster of other high-tech firms to Jena and its vicinity.

More troubling is the suspicion that a man with so big an ego may be loth to submit to cabinet discipline. He admits he is impatient. “In business,” he used to say, “I can take decisions and really change things.” In politics, matters are less simple. He has already caused a fair bit of confusion as Mr Stoiber's adviser by expressing views that flout the party line. While Mr Stoiber is blithely pledging ever more billions of euros to defence, child benefit, schools, small businesses, eastern Germany, hospital doctors and so on, Mr Späth drily notes that the public deficit is already dangerously close to the EU's 3% limit. While the Bavarian leader promises to cut taxes immediately, his economics guru suggests that some taxes might at first have to go up. Mr Späth points out that whatever the next government's hue it will have little room for manoeuvre. While Mr Stoiber casts opprobrium on the Schröder government's tax-reform ideas, Jenoptik's boss applauds them. While Mr Stoiber implies that radical change can take place overnight, Mr Späth cautions that some of the conservatives' proposals could take years to implement. While Germany's possible next chancellor dismisses Mr Hartz's labour-market proposals as the “biggest bluff ever”, his designated employment minister welcomes them as “revolutionary”.

Is he sure he really wants it?

Some think Mr Späth is having second thoughts about his new job. He did not seem his usual perky self alongside Mr Stoiber when they launched Offensive 2002 last week. He probably knew it was just a rehash of previously announced ideas and would rely on cash not yet available. But there is little doubt that Mr Späth has the energy and will to drive through the kind of reforms Germany sorely needs.

He also enjoys public trust. Indeed, if Mr Schröder squeaked back into power, he might conceivably ask him to join his team. Mr Späth has already hinted he might not be against that idea. Many Germans, on left and right, might cheer.

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Spending review

The £61 billion question

Jul 18th 2002
From The Economist print edition

Reuters

Gordon Brown has opened the vaults. But that does not guarantee a golden future for Britain's public services

Get article background

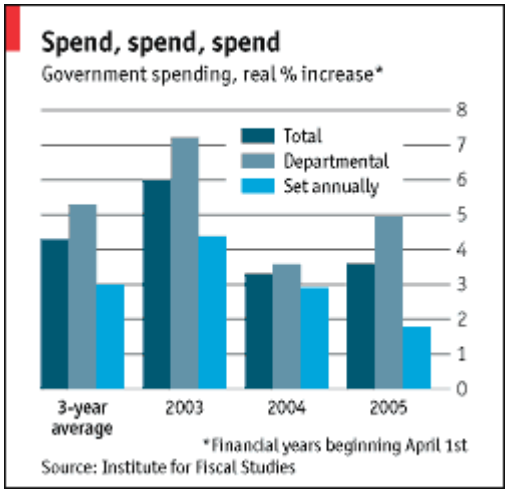
TO SPEND or not to spend: that is the question facing any chancellor. Gordon Brown confronted it when he moved into the Treasury in 1997. But that was then, and he has long since cast off his early role of Scrooge. This week, Mr Brown flung yet more money at the public services, increasing departmental budgets by over 5% a year in real terms for the rest of this Parliament. Together with past increases since April 2000, the three-year plan which runs to spring 2006 will deliver the biggest sustained boost to public spending for 30 years.

In his April budget, the chancellor had already announced a five-year programme to raise spending on the National Health Service by 7.3% a year in real terms. He also set out his three-year plan for total public expenditure, which is set to increase from £418 billion (about $650 billion) this financial year to £511 billion in 2005-06. That increase of £93 billion translates into an average rise of 4.3% a year after inflation.

What Mr Brown did in the spending review was to allocate this extra expenditure to individual ministries, other than health. His first decision was how much more to set aside for the part of the budget set every year—predominantly pensions, welfare payments and debt interest. His answer was an increase of £32 billion. This in turn left Whitehall's big spenders with £61 billion extra in their departmental budgets over the next three years, an average annual increase of 5.2%. With £22 billion of this increase already allocated to the NHS, that still left £39 billion for other departments. So everyone was a winner, though some ministers like Estelle Morris, the education secretary, clearly had more to celebrate than others (see article).

Much of the increase is front-loaded (see chart). Next year, total spending will rise by 6%, and departmental expenditure by over 7% in education, the NHS and transport. An obvious question is whether departmental spending growth will in practice decelerate so sharply after 2003-04. “The three-year expenditure plans are supposed to set fixed and firm limits, but so far they have been floors,” points out Andrew Dilnot, director of the Institute for Fiscal Studies (IFS). Another doubt is whether annually-set expenditure, which includes state pensions, will grow as modestly as expected from 2004-05. As the election approaches, there will be political

pressure to hand more money to Britain's 11m pensioners, just as happened before last year's election.



Even if Mr Brown can hold the line on these plans, his spending fiesta amounts to a double gamble. First, he is betting that these increases are affordable, in bad times as well as good. Second, he is hoping that the extra cash will deliver value for money.

As the chancellor spoke, the FTSE 100 index of leading shares was tumbling and closed below 4,000 for the first time since 1996. The losses in the stockmarket were an uncomfortable reminder that Mr Brown may be able to set three-year spending plans, but their viability rests on the economy performing well. After stalling around the turn of the year, the economy has appeared to be on the path to recovery. With equity markets in retreat, that prospect looks less certain. But with net public debt currently only 30% of GDP, the lowest ratio in the Group of 7 leading economies, the government is well placed to ride out a renewed economic reverse.

Even so, Mr Brown is not in the same extraordinarily strong position that he was at the time of his last spending review two years ago. Then, the Treasury was awash in cash: in 2000-01, the government ran a surplus of £16 billion. Many of the ambitious increases in public expenditure could therefore be paid for by running down the surplus. This year, in contrast, there will be a deficit. The Treasury forecast one of £11 billion in the budget, but that was based on a more rapid upturn than now seems likely. Michael Saunders, an economist at Citigroup, thinks that public borrowing will be about £18 billion.

Taxes are going up next year to pay for some of the extra spending announced this week. But the chancellor is also assuming higher long-run economic growth in his economic forecasts than he used to. This has removed the comfort margin that he used to such effect in the run-up to the last election, as he gave away some of the proceeds from a buoyant economy without blowing a hole in the budget. And even if the economy does grow according to plan, it may simply generate less tax revenues than expected. “The good fortune the Treasury enjoyed on the public finances in its first term is less likely in its second term,” says Mr Dilnot.

Hard labour

But even if Mr Brown's plans turn out to be affordable for the rest of this parliament, he still has another big bet on the table. Will the extra resources deliver value for money? The chancellor must surely suffer a waking nightmare: that the cascade of extra cash ends up in higher pay or allows lower productivity rather than delivering improved public services.

Some rises in public-sector pay are both inevitable and desirable. If the NHS is to recruit more staff, it has to raise its pay rates. But already there are warning signs that too much of the extra cash is simply stoking up public-sector pay inflation. In the financial year that ended this March, earnings grew by more than 5% in the public sector and outstripped those in the private sector for the first time in nine years. On July 17th, a million local-government workers held a one-day strike to support an inflation-busting pay demand.

Mr Brown is aware of the risks to his strategy. He used his statement to the House of Commons on July 15th to warn unions that “a sustained commitment to better public services demands responsibility in setting public-sector pay.” His speech was peppered with talk about setting targets, regular reporting of performance against them, tough scrutiny and inspection and severe sanctions against failing public-sector institutions.

The trouble with talking tough on pay is that the unions know that the money is there. As for targets, there is nothing new about them: the Treasury has been setting them since its first spending review in 1998. However, there is no agreement on how successful the government has been in meeting them, still less on whether they really drive improved services. The record so far is hardly encouraging. The NHS has been subjected to a battery of targets and initiatives, but its productivity has been declining.

Targets, backed by inspection, are essentially an attempt to command and control the public services from the very centre of government, the Treasury. Ministers now appear to recognise the need for

greater local autonomy—they certainly pay lip service to it—but the overall system remains extraordinarily centralised. There is good reason to doubt whether such a command-and-control regime can work. “It creates a blame culture within the public services, which stifles local initiative,” says Steve Robson, former second permanent secretary at the Treasury. Directives from the centre are no substitute for the empowerment of individual consumers which would create real incentives to provide better services.

It would be incredible if all the extra cash being ladled into the public services did not deliver some recognisable improvement. But the way in which the cash is being pumped in militates against success. The clear and present danger for the Labour government is that voters may conclude that their higher tax bills are not bringing them public services that are sufficiently better.

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Who gets what...

Feeding the beast

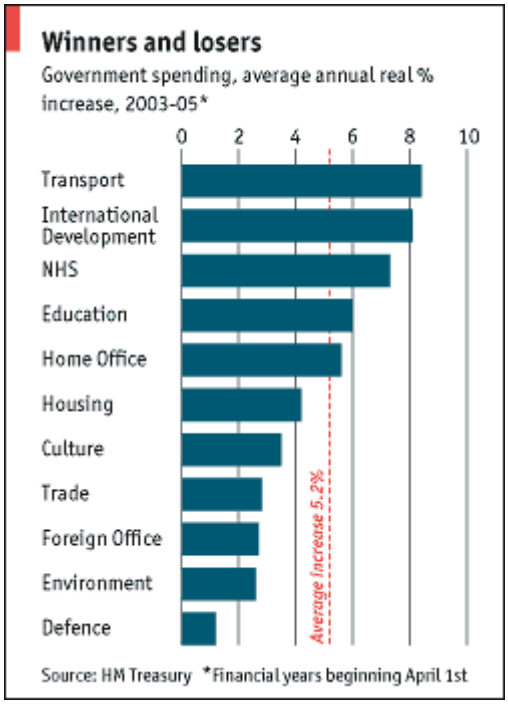
Jul 18th 2002
From The Economist print edition

...and what they're supposed to do with it

Get article background

THE National **Health** Service was the top recipient of the Chancellor's munificence: NHS spending will grow by 7.3% a year until 2007-08. But because that pick-me-up had already been announced, the spin circled around **education,** which is arguably in a worse state.

Education spending in England will rise at an annual rate of 6% for the next three years. From next year, more money—though still a tiny fraction of their overall budgets—will go direct to schools. Extra grants of £125,000 ($195,000) will be available for 1,400 schools in "challenging" areas. Weekly payments to keep under-privileged teenagers in school will be available nationally from 2004.



But this is not—as the education secretary unsurprisingly avowed—money for nothing. It will be accompanied by what she modestly described as reform of "unprecedented ambition" in secondary schools, which were relatively neglected during Labour's first term.

As well as the inevitable exam targets, a sort of mock-market is supposed to be created among schools. Bad head-teachers will be sacked, and bad schools closed or taken over by successful ones. High-achievers will be given more freedom. There will be more "Academies"—in effect, state-funded independent schools—and many more of the government's beloved "specialist" schools, which are allowed to do a spot of selection. More than half of secondary schools are supposed to be specialist by 2006. A new breed of 300 "advanced" schools will appear.

The **Home Office** also won a hefty boost—5.6% a year—to help speed up the asylum process and to provide £1.5 billion more for the police in 2005-06 than in 2002-03. The aim is to secure big cuts in burglary, vehicle crime and robbery. A wedge of cash will pay for affordable **housing** in London and the south-east, and for public-sector workers. **Transport** spending will also rise sharply, from £12 billion this year to £16.4 billion in 2005-06. By then, the overseas **aid** budget will have risen by 93% in real terms since 1997. **Defence** gets its largest sustained rise in two decades.

Among those celebrating will be **auditors**. More audits and inspectorates are promised—for criminal justice and for housing, as well as for the NHS. Across government, there are a variety of new pots of money to be bid for—all of which means more tedious form-filling, known, in weary public-sector circles, as "feeding the beast".

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Northern Ireland

The IRA says sorry (sort of)

Jul 18th 2002 | BELFAST
From The Economist print edition

The IRA's apology won't make David Trimble's life any easier

Get article background

THE unprecedented and gut-churning apology from the IRA on July 16th for the “non-combatant” deaths the terrorists caused over 30 years of a campaign that killed nearly 1,800 people elicited a predictable response: a muted welcome from the British and Irish governments and bitter scorn from unionists.

The sharpest words came from David Trimble, the leader of the Ulster Unionist Party and first minister, who warned Tony Blair not to use the IRA's statement as an excuse to refrain from taking tough measures against the paramilitaries for breaches of the ceasefire. Mr Trimble has given Mr Blair a deadline of July 24th to try and restore fast-ebbing unionist support for the Good Friday Agreement. Mr Trimble, who is under mounting political pressure, blames disillusionment with the peace process on what he describes as the insincerity and cynicism of the IRA. He noted that the apology made no reference to “the recent violence that the IRA has been involved in, nothing about what their future conduct is going to be.”

Mr Trimble was referring to the arrest in Colombia of three republicans who are due soon to stand trial on charges of assisting local guerrillas; the break-in at the Castlereagh police headquarters; orchestrated rioting on the streets of Belfast; and recurring allegations from police sources that IRA surveillance of potential targets continues. By the end of the month, Mr Trimble wants Mr Blair to declare the IRA ceasefire a sham and to expel its political wing, Sinn Fein, from the power-sharing devolved administration in Stormont.

The likelihood of that happening now appears extremely remote. Almost as the IRA issued its statement, Mr Blair was assuring the House of Commons that, in his view, the IRA was now farther away than ever from a return to violence—choreography, sneered suspicious unionists. Later on, Downing Street described the IRA's initiative as an attempt to draw a line under the past. And Mr Trimble's hopes had been fading anyway. After initial fury in both London and Washington, there now seems little appetite for playing up the Colombian affair, and some people think that Castlereagh may have been an inside job carried out by elements from within the intelligence services rather than the work of the IRA.

The timing of the IRA's apology, coming just five days before the 30th anniversary of a particularly horrible atrocity in Belfast that became known as Bloody Friday, was either crass or poignant, depending on your point of view. On that day in 1972, after a series of inadequate and confusing warnings, nine people were killed and scores badly injured by 20 explosions that took place across the city inside 75 minutes. Many people believe that Sinn Fein's president, Gerry Adams, in his previous capacity as an IRA leader, helped to plan Bloody Friday.

The IRA statement took Bloody Friday as its reference point: “While it was not our intention to injure or kill non-combatants, the reality is that on this and a number of other occasions, that was the consequence of our actions. It is therefore appropriate on the anniversary of this tragic event that we address all of the deaths and injuries of non-combatants caused by us.”

The IRA's distinction between “combatants” and “non-combatants” seemed to many of the bereaved families a typically sickening piece of hypocrisy. The terrorists' softest targets were frequently the part-time soldier and farmer shot dead on his tractor or the policeman making a cup of coffee in his kitchen before going to bed. That said, loyalist paramilitaries were widely praised at the time of their ceasefire announcement eight years ago, when they singled out the death of “innocents” as a cause for “remorse”. Many Catholics, killed at random, were conveniently described by their killers as IRA members.

Just a few hours after the apology, a police jeep in rural County Down was struck by an explosive device. Security-force sources suggested it was the work of dissident republicans responding to the IRA's “sell-out”. Many unionist politicians, however, insist that such “dissidents” are simply proxies for the IRA.

Overall, however, tensions are easing with the passing of the peak of the Orange marching season, and the police believe that loyalist attacks against Catholic targets are outstripping violence by republicans. One senior officer even praised the IRA for helping to damp down riots in Belfast over the Twelfth of July weekend.

Meanwhile, Mr Trimble's future is uncertain. Mr Blair is anxious to do whatever he can to bolster him. But whether he can do enough to get him to withdraw, or, failing that, postpone, his veiled threat of resignation is not clear. And if Mr Trimble backs down, as he has in the past, there remains the distinct possibility that his increasingly fractious party will move against him. If the IRA's apology has helped to make Mr Trimble's life even trickier, it will no doubt feel that it has served at least one of its purposes.

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Local government

Looting the gold mine

Jul 18th 2002 | HULL
From The Economist print edition

What half a century of one-party government has done to Hull

UNTIL the 1990s, most of Britain's big northern cities were Labour one-party states. Assured of staying in power, many councils acted accordingly. Money disappeared through bad management and dishonesty. Council taxes soared. Eventually the electorate got fed up, voted in Liberal Democrats or coalition governments, and the councils were reformed.

Now it's Hull's turn. Three months ago, in the city's local elections, the Lib Dems and Independents seized power after half a century of Labour rule. They are looking for answers to some interesting questions. The biggest is how, three years after unearthing a £263m goldmine, the council now finds itself nearly broke. The answers could damage John Prescott, the deputy prime minister and MP for Hull East.

At first glance, Hull is thriving after years of mouldering quietly away on the Humber estuary. Three months after it opened, the Deep, a £45m aquarium boasting the deepest fish tanks in Europe, has attracted 250,000 visitors, as many as it hoped for in its whole first year. A swanky 25,000-seat, £43m stadium to house the local football and rugby-league teams is rising on the city centre's western edge. A £150m regeneration scheme is planned around the main railway station.

But Hull is still in decline. About 10,000 of the city's 115,000 houses are empty. Its population—down from over 300,000 in the 1940s to 257,000 in 1999—still seems to be falling. Unemployment, at 6.9%, is well above the Yorkshire and Humberside average of 4.1%. Two-thirds of households have incomes of less than £15,000.

In an effort to do better, the city council decided three years ago to exploit its biggest asset. An accident of history meant that, uniquely in Britain, Hull had its own, council-owned telephone company. Cashing in on the 1990s telecoms boom, the council sold 55% of Kingston Communications, raising £263m. Much of the money went on repairing council buildings (£32m), fixing schools (£35m) and mending roads and pavements (£37m). Another £32m went on the stadium.

The biggest chunk, £96m, is being spent on putting central heating and double-glazing into 25,000 of the city's 38,000 council-owned houses. Yet about 3,500 of these houses are empty and people are still pouring out of Hull, many to the next-door East Riding area where the schools are thought to be better. A report to be published on July 25th by the Audit Commission, a council-spending watchdog, reckons that Hull's council-housing account will lose £1.4m this year and that reserves will be exhausted by 2006.

The commission, shocked by the state of the council's housing department, is likely to urge Mr Prescott's local-government ministry to take it over. Labour councillors, however, are bitterly opposed to that. A fight between Mr Prescott and his local Labour Party seems certain.

But that's not all. Chris Jarvis, an independent councillor now in charge of housing, has asked an independent auditor to probe a deal the council struck in 1995 with Keepmoat, a private developer, to rebuild Gypsyville, a run-down council-housing estate. This was supposed to bring the council a £3.8m share of profits. Instead, the scheme has lost money, and the council has had to pump in an extra £6.7m.

The Gypsyville failure is, at the least, an embarrassment for Mr Prescott, who championed it as the kind of public-private venture the government is keen on. But even if no grime emerges from the audit, there is a bigger question: why, when Mr Prescott was in charge of local government from 1997-2001, did he allow such a mess to fester on his own doorstep?

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The Commonwealth Games

Ready and steady

Jul 18th 2002 | MANCHESTER
From The Economist print edition

The games might just succeed, on and off the track

They looked and leapt

COVERING up its usual grey and grimy face, Manchester is currently a riot of red, blue, green and yellow. Banners and flags hang from every lamp-post, bunting drapes across shops and offices, and flowers are sprouting all over the place. The Commonwealth Games, with about 5,000 athletes from 72 countries of the former British empire (including, outrageously, Zimbabwe), start in the city on July 25th, and the council is determined to make a splash. When it all disappears two weeks later, however, a good many citizens are worrying about the size of the bill that will come through their doors.

The games will cost the council £70m-80m, about £45m more than was originally budgeted. Over the Pennines, Sheffield is still paying for the 1980s debacle of the World Student Games it staged. Some Mancunians fret that the closure of a swimming pool and some housing offices foreshadows other cuts in services that will be needed to balance the books.

“I'm not worried,” says Howard Bernstein, the chief executive. The pool and offices were hopelessly expensive and would have been closed anyway. Neither, he says, will council taxpayers have to stump up; the council has promised inflation-only council-tax increases for the next three years. In fact, despite a shortfall in expected TV revenues and some missing sponsors, income from the games, at £58.1m, is close to budget. The net all-in cost is just over £200m, two-thirds of which central government will pay.

Mr Bernstein says the council's share is being met out of reserves built up over the past decade and out of its slice of profits from its half-ownership of Manchester airport. More money will be brought in by sales of land in East Manchester close to the stadium to private firms, most of which would not have taken sites there as a gift a few years ago.

A report by Cambridge Policy Consultants reckons that the games have generated close to £500m in private investment in East Manchester, creating about 2,300 jobs in an area which has been derelict for a decade. Some 4,400 jobs have also been created in the city and the rest of the north-west. Firms, such as Asda Wal-Mart, have been encouraged to build stores in a new town centre being created there, and ICL, a computer company, is moving all its Manchester activities to a single site in the area. As a sport-led regeneration project, boasts Mr Bernstein, it rivals Barcelona's achievement with the 1992 Olympics.

Manchester is unlikely to get the extra tourists that the Olympics brought Barcelona, though the city hopes for 300,000 extra visitors a year. But it can claim that, unlike many other games-hosts, it will not be left with white elephants—the main stadium, for example, will become the home of Manchester City football club. And it cost £110m, a bit less than has so far been spent turning London's Wembley stadium into a derelict hulk.

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Criminal justice

Tough love

Jul 18th 2002
From The Economist print edition

David Blunkett has revealed his criminal justice blueprint

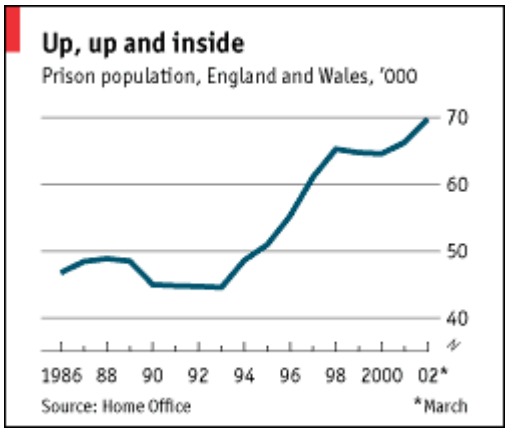
Get article background

THE home secretary is a perplexing politician. One minute he is digging in his heels; the next he is prostrating himself in apology. Sometimes he wants to rehabilitate criminals; at others he wants to throw away their key. This split personality was evident on July 17th, when he published a white paper containing his many ideas for reform of the criminal justice system.

Not all of them will become law soon or ever. Some are sensible—such as introducing formal plea-bargaining to cut the number of pointless trials, and giving witnesses better protection. Bail should indeed be denied to suspects who reoffend while awaiting trial; and so on. Elsewhere, the messages are characteristically mixed.

Take prisons. Despite declining conviction rates, the prison population has been rocketing (see chart), as courts have become fonder of incarceration. In the West Midlands, the jails are so full that prisoners are to be deposited in police cells. Yet for many criminals, prison is useless or worse; at the last count, half were reconvicted within two years of release; the proportions for young offenders and those on short sentences are even higher. So the white paper discusses various alternatives: a new kind of suspended sentence; weekend prison; and a short taste of porridge followed by community supervision. At the same time, it recommends tougher sentences for persistent criminals, and indeterminate ones for still-dangerous violent and sexual offenders.

There is even greater ambivalence on the sensitive subject of juries. Fewer than half of those selected for jury service do their civic duty; so the white paper recommends various ways to undermine the old adage about a jury being made up of 12 people too stupid to get out of it. Mr Blunkett has dropped his predecessor's plans to restrict the right of some defendants to opt for jury trials. But other proposed reforms will reduce their number. The sentencing power of magistrates could be increased from six months to 12, and possibly more, which will keep some cases out of the crown court. In cases where juries are, or might be, intimidated, judges could opt to try the case themselves; ditto serious fraud cases, which are often long and complicated. (The Bar Council opposes this notion of “executive justice for executives”.)



Libertarians who worry about the thick end of wedges will also be alarmed by some of Mr Blunkett's other ruses for “rebalancing” the system in the victim's favour. For instance, previous convictions (and even acquittals) may become admissible evidence in many more cases—with serious implications for that quaint tradition, the presumption of innocence. (The Bar Council worries about the emergence of a “usual-suspects culture)”. Likewise, that pesky technicality, the double jeopardy rule—whereby no one is tried more than once for the same crime—could be set aside for serious violent and sexual offences. Mr Blunkett thinks that late-discovered DNA evidence should have its day in court; he may also be thinking of the galling kill-and-tell autobiographies penned by some acquitted murderers. What he may get is sloppy and vindictive policing.

John Wadham, head of Liberty, a pressure group, says that “eroding the rights of suspects and defendants won't reduce crime, but it may result in more innocent people being locked up”. But Mr

Blunkett's desperation to reduce crime by fair, foul or speculative means is understandable. Figures published last week suggested that the recent fall in crime had slowed or ceased. According to one measure, robbery increased by 28% last year. Statistically, the risk of becoming a victim is around its lowest for 20 years, but many voters see it differently.

The detection rate, meanwhile, is stuck at below a quarter. Yet the white paper and Mr Blunkett are much crosser about the prevarications and shenanigans of unscrupulous lawyers than about the failures of the police. Courtenay Griffiths QC—whose annihilation of the chief prosecution witness in the recent Damilola Taylor murder trial probably qualifies him as one of Mr Blunkett's meddlesome lawyers—says that his profession has been seized upon as a convenient scapegoat.

But perhaps this scorn for the legal profession, and these proposals, are not only the product of populism combined with pragmatism. If anything, they suggest a touching faith in politics. Despite the recent glut of criminal justice acts, Mr Blunkett still thinks politicians can cure the courts and reform those naughty lawyers.

They also enact the political philosophy Mr Blunkett sketched in a recent, plodding book. In brief, he thinks that opportunities should be thrust upon the unfortunate (such as misguided young offenders), but that adults who shirk their responsibilities, or persistently screw up, deserve everything he gives them. This tough-love attitude may derive from his own tough background; it is also, possibly, a stern version of the “third way”.

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Bagehot

The wrong sort of bravery

Jul 18th 2002
From The Economist print edition

Gordon Brown has thrilled and terrified his colleagues in equal measure

Get article background

GREAT acts of recklessness are always impressive to behold. We marvel at the kind of self-belief that insists, in spite of everything we suspect to the contrary, that all will be well. We tremble at the prospect of what awaits if it is not. Observing Gordon Brown this week, as he outlined his plans to increase public spending by £90 billion ($140 billion) within the next three years—the equivalent of £10 a day for every household—induced just such feelings of admiration combined with trepidation. Mr Brown told us that every eventuality had been foreseen, no detail left unattended. Nothing had been left to chance. Prudent was how he wanted us to see him, but brave—ridiculously, fecklessly, damn-your-eyes brave—is how we did.

Let's be clear about the nature and the scale of the risk that Mr Brown (and Tony Blair, for in this, the friend-rivals are in lock-step) has decided to run. It is not that the government fears voter hostility to the increasing weight of taxation (at least, not yet). So far, Mr Brown's tax rises have largely been borne by the relatively well-off and, anyway, the argument that the core public services have been chronically under-funded for years has been painstakingly won. Nor should we doubt the chancellor's confidence when he claims to be unworried about being blown off course by financial-market volatility. Most of the money he intends to spend over the next three years is pretty much in the bag already, thanks to his tight-fistedness in earlier years. Even an economic dip in 2003 shouldn't place too much strain on the numbers as long as it is neither too deep nor too lasting. And if something really nasty is in store, the government calculates that it can blame events beyond even Mr Brown's control.

By far the greatest risk is that even the heroic sums of money that are now being thrown at public services won't make the hospitals and the schools discernibly better. But here's the funny thing. For all Mr Brown's bravura display, it's not just desperate Tories (whose future hopes rest squarely on government failure) and cynical hacks who think it will all end in tears. There are real doubts within the government itself. Speak to almost any group of senior civil servants in one of the big spending departments, the people the government is counting on to make sure that the systems are in place for the money to be used effectively, and you quickly detect a palpable foreboding. They know what's being asked of them and they are acutely aware of how much rests on their shoulders. To an extent, that's a tribute to the pressure that ministers are putting them under and some indication of the impact that the new public-spending agreements are having, flawed and muddled though many are. But their tension is not just of the creative variety.

Take just one area: the hopes being invested in the ability of new IT systems to transform the efficiency of the NHS. With a budget of more than £5 billion to be spent over the next three years, the civil servants involved say that “failure is not an option.” But with serial government IT disasters to ponder and lessons only partially learned, they know that not only is failure an option, it's the outcome many would bet on.

Out of excuses

Among ministers, the mood is slightly different. To be sure, there's excitement about the extra money flowing into their departments and talk of this being what they came into politics to do. But there's little triumphalism. Several are already doing their best to play down expectations about the wonders that Mr Brown's largesse will achieve. They are only too well aware that public-sector inflation is already running at 6.5%—double the rate for the economy as a whole—because of capacity constraints and increasingly

generous pay settlements. The King's Fund, a pro-NHS health think-tank, says that it expects nearly half the money earmarked for better health care will go straight into the pockets of producers. Ministers are grimly determined to do their best to avoid such leakage and accept that there can be no excuses, but there's real fear that the levers they're holding may not be attached to anything.

The more thoughtful Labour MPs, while applauding the government's intentions, are openly sceptical of its mantra of “investment tied to reform”. Old Labour types love this sort of thing, but others fret that not enough has been done to prepare the way for Mr Brown's gusher. Even the prime minister, during his otherwise impressive and marathon performance before the massed ranks of select committee chairmen on Tuesday, came close to expressing doubts. There was a conflict, he admitted, between devolving effective responsibility to local managers and ensuring every tax pound was properly accounted for. He appeared to acknowledge that if there was a right answer, he had yet to find it.

Seemingly, the chancellor stands magnificently alone in his certainty. However, the very things that he is most often criticised for—the obsessive monitoring; the ever-more detailed centrally determined targets; the setting of bureaucratically-derived standards; the relentless demands on managers to record and report everything they do—are themselves an outward expression, like his bitten-to-the-quick nails, of an intense and probably growing anxiety. One can only wonder at the extraordinary intellectual effort, ingenuity and cost that has been expended on creating these systems for forcing “delivery” from structures that Mr Brown has come to realise are inherently unresponsive either to large inputs of funding or to meeting the real needs of consumers.

What is so difficult to understand is why, given what the chancellor knows, he has applied his formidable mind and unrivalled tenacity in this way rather than in grappling with those structures themselves. The mystery is not that the chancellor is willing to take a great political risk, but that he is prepared to stake so much on taking a risk of the wrong sort.

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Transformed?

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From The Economist print edition

AP

Since September 11th, the world's interest in defence has revived for the first time since the end of the cold war. But the industry has to reinvent itself to suit changing needs, writes Iain Carson

DEFENCE is not like any other industry. Its output—the ability to deliver death and destruction, albeit mostly in the name of deterrence, peace and security—makes it unloved outside the communities where it provides jobs. With essentially one tax-funded customer per country—the government—that hardly matters. But the September 11th terrorist attacks on America may have fundamentally changed people's perceptions of the industry.

Byron Callan, a defence-industry analyst at Merrill Lynch, an investment bank, has an office next to what used to be the World Trade Centre in New York. “When the second plane hit, we all started to leave our building,” he recalls. “By the time the second tower fell, we looked up to see an F-15 fighter circling overhead. Everybody cheered and clapped. That's the difference: people are more defence-minded, and it's carte blanche for the defence budget.”

For the world's stockmarkets, September 11th was a “buy” signal. Stocks of defence companies soared after more than a decade in the doldrums caused by the fall of the Berlin Wall. Vance Coffman, the boss of Lockheed Martin, the world's biggest defence company, thinks the aftermath of the terrorist attacks will translate into annual increases in American defence spending of 10% or more. He also expects it to lead to a transformation in military systems, with a new emphasis on precision weapons and mobility, the better to fight enemies who may be difficult to pin down.

Transformation is the military buzz-word for a change from heavy, slow-moving forces to lighter, more agile units, employing the latest information technology to wage computerised warfare. It is also known as RMA (revolution in military affairs). Andrew Krepinevich of the Centre for Strategy and Budgetary Assessment, a Washington think-tank, and a strong advocate of RMA, thinks that “9/11 is exhibit A for transformation.” For Jim Thomson, who runs RAND, America's leading defence-analysis organisation, “It will give transformation more impetus.” Jerry Daniels, boss of the defence business of Boeing, expects the consequences of that fateful day to include a new emphasis on defending the American homeland, greater interest in pilotless aircraft (known as unmanned air vehicles, or UAVs) and the realisation that winning a war now depends as much on superior information as on dominance of the skies.

President George Bush has promised to raise the annual defence budget to more than $400 billion over the next five years, and within that total many observers expect the procurement budget to climb back above $100 billion, after a slump to around $50 billion last year from its peak of $150 billion under

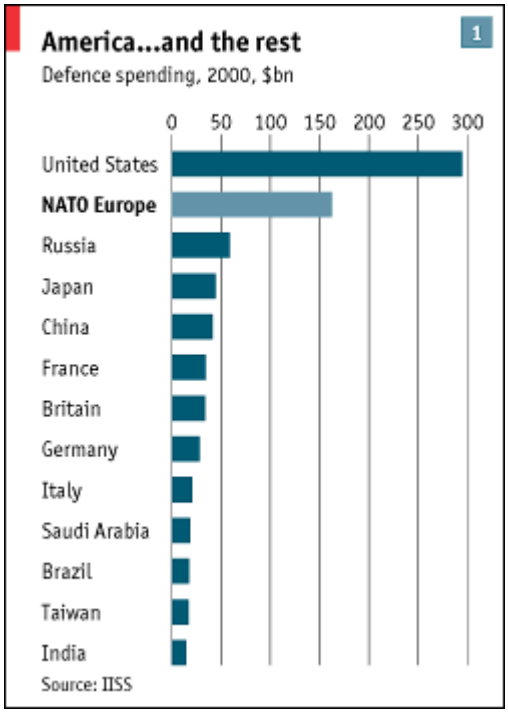
President Reagan in the mid-1980s.

Not everybody thinks the extra money will necessarily go on more weapons. Jay Korman of DFI, a Washington defence think-tank, expects much of it to be spent on neglected maintenance, pay and other benefits rather than on more fighters, ships and missiles. And even in America, defence has not become everybody's favourite business. But most analysts feel sure that the terrorist attacks will give a long-term lift to America's defence industry.

Cyberwars

In fact, big changes in the industry were under way long before last autumn. They had their roots in the collapse of the Soviet Union; in the victory of the allied forces in the Gulf war; and in the technological possibilities that emerged in the 1990s for new kinds of warfare, using spy satellites and smart missiles rather than boots on the ground. American operations in Afghanistan already have more in common with computer games than with the trench warfare of the first world war or the blitzkrieg of the second. But they are seen only as forerunners of the “network-centric” RMA warfare of the future, when everything from spy satellites to aircraft to ground soldiers with laptops is wired together to ensure complete knowledge and the ability to respond instantly.

To prepare itself for this brave new world, the industry in America has been consolidating rapidly, leaving only five big prime contractors. Further changes are under way. For example, in the past couple of years Northrop Grumman, a maker of bombers, fighter jets and the fancy electronic systems they carry on board, has also become the world's biggest naval shipbuilder, acquiring two naval shipyards, Litton Industries and Newport News. Kent Kresa, Northrop's chairman, sees warships as more than just platforms for launching aircraft or missiles: to him, they are “nodes” in the electronic wars that will be waged far from traditional platforms turned into moving bases. A few years ago ships seemed to be going out of fashion, but now visionaries such as Mr Kresa see them as an essential part of RMA. However, Mr Kresa also envisages other nodes, hundreds of miles above the earth, as space becomes increasingly militarised. On July 1st he bought TRW electronics, an aerospace and car-parts company, mainly for its satellite business.



Fifty years ago, high spending on defence fuelled by the cold war produced many technical breakthroughs, from semiconductors to nuclear power, which brought great benefits to the rest of the economy. Now, if anything, the flow seems to have been reversed, with the defence industry looking to rapidly advancing technology in commercial industries such as electronics and computer software to keep weapons up to date. But barriers between defence and other industries remain difficult to overcome. High hopes after the collapse of the Soviet Union that defence would reshape itself into a normal global industry have been dashed. What has emerged instead is a business worth around $200 billion worldwide in which America dominates, Europe trails behind and the rest of the world is just a collection of mostly outdated industries or subcontractors to the Americans. There is a sense in the United States that the government is less open to dealing with foreign suppliers than it was before September 11th, because of heightened fears about defence technology leaking to undesirable governments or organisations.

For the past half-century, there has been a marked disparity in defence spending between America and Europe, which survived the end of the cold war. On average over the years, the Americans have been spending 50-100% more on defence than the Europeans, despite lower taxes. If necessary, they have choked off other domestic spending, such as social programmes, to find the money. In America, in current circumstances no one is going to vote against defence increases.

By contrast, in Europe government spending takes up a larger share of the economy and defence is always an easy target for cuts. This is particularly true in Germany. “Since the collapse of the Soviet empire,” says one British diplomat in Washington, “the Germans simply think the enemy has gone away.” Other than in Britain and France, defence budgets will remain flat everywhere.

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Odd industry out

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Making arms is different in kind from making widgets

JSF stands for Jointly Spent Fortune

THE defence industry is peculiar in several ways. It is about the only large industrial sector that sells almost exclusively to governments, leaving aside the illicit trade in small arms to drug smugglers and terrorist groups. “Defence is driven by non-economic forces,” says Loren Thompson, of the Lexington Institute, a Washington think-tank. That makes it unpredictable, especially in America, where procurement of weapons systems depends on a troika consisting of the Defence Department, the White House and Congress. Each year Congress votes on the amount of money that will flow to the Defence Department. That can lead to sudden cuts in the numbers of, say, fighters or missiles ordered in a weapons programme.

In the European countries that spend most on defence—Britain, France and Germany—the procurement process may be more straightforward, but programmes are just as liable to be challenged and changed when government money becomes tight. The current plan for a new European troop-carrying aircraft (known as the A400M), to be built by Airbus, was delayed for years because some politicians in Germany's Green Party blocked the money needed to buy the number specified in the initial order.

Because the defence industry spends taxpayers' money, politicians feel justified in interfering. This goes well beyond the legitimate role of trying to ensure that the industry can deliver reliable weapons at a fair price, and often comes down to pork-barrel politicking. The combination of national security concerns and government funding explains why defence enjoys some immunity from the usual pressures of international business. Even when it sells to other countries, the industry needs government approval to ensure that technology does not get into the wrong hands. And often the importing country imposes stiff conditions, requiring the supplier to create jobs within its own borders.

Siamese twins

To complicate things further, defence and civil aerospace are joined at the hip. Aerospace products, from aircraft to missiles, form the biggest chunk (more than half) of defence procurement budgets. Although civil aerospace companies sell to around 200 big airlines the world over, many of these are government-owned and run for reasons other than purely commercial ones. Both the civil and the military sides of aerospace involve highly capital-intensive products. This in turn affects the shape of the industry.

Sir Richard Evans, chairman of BAE Systems, Europe's largest defence aerospace company, says the high capital costs propel companies to find partners for both military and civil projects. This has led to a web of relationships in which defence aerospace companies can be competitors on one product and collaborators on another. BAE, for instance, is part of the Lockheed Martin team to build the Joint Strike Fighter (JSF) for America and Britain, but has joined up with Boeing to build the new European Meteor guided missile.

Defence aerospace is a bit like a cottage industry, says Sir Richard, in that the number of customers is small, everybody knows everyone else and everything is connected. “If Vance (Coffman of Lockheed Martin) or Phil (Condit, chairman of Boeing) is in London, I'd be upset if they didn't call round for a cup of tea,” he says.

If this degree of socialising went on in any other industry, competition authorities would kick up a fuss.

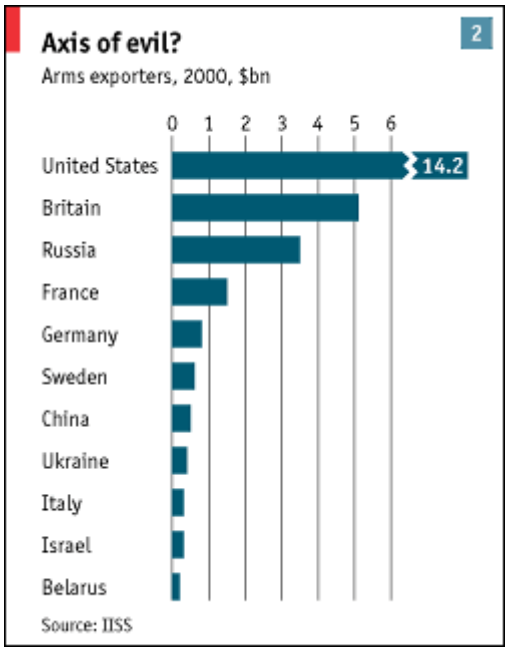
But in defence, contracts are few but huge, and customers are few but powerful, so market forces do not work. “Defence is not normal,” says Harvey Sapolsky, a defence expert at the Massachusetts Institute of Technology. “It's an allocated business. If you don't get a contract, you get a portion of it.”

Moreover, defence companies are often subsidised, whether directly or indirectly. Weapons procurement is often justified in terms of jobs, not just strategic benefits. And there are plenty of jobs involved: in America, for instance, the top seven defence firms employ about 1m workers.

Export-credit subsidies and government aid often go hand in hand with arms export deals. Much diplomatic effort is expended on trying to land such deals abroad. The British government even has a director of arms sales based in the Ministry of Defence, whose job it is to promote sales of British weaponry abroad. The only other sector in most rich economies to be so coddled is farming.

Because of its unusual status, the industry has traditionally been unpopular, and not just with left-wing peaceniks. To many people there is something spooky and secretive about the whole sector. In his valedictory speech in 1961, President Eisenhower, hero of the Normandy landings, advised his fellow Americans to be wary of the military-industrial complex. Almost exactly 40 years later, another prominent Republican, Senator John McCain, was on his feet in the Senate denouncing Boeing over a $20 billion deal to lease refuelling tankers for only ten years. Mr McCain, who in the past year has delivered 18 blistering Senate speeches on sneaky additions to defence spending, describes the Boeing deal as “obscene war profiteering”. The air force says it is a handy way of getting hold of much-needed new tankers in a hurry. Curiously, a similar proposal (though on a smaller scale), which involves Boeing and BAE Systems providing tankers and a whole refuelling service for Britain's Royal Air Force, has met no challenge so far.

Public opinion supports increases in defence spending only in the face of obvious threats, such as the terrorist attacks on September 11th. But if the public is mostly unenthusiastic about defence spending, it is decidedly hostile to the international arms trade, despite its job-creation potential. Exports of military hardware run at nearly $40 billion a year, according to the Stockholm International Peace Research Institute (SIPRI). Some observers say America's share of that is close to half, which sounds about right, given that the world's only superpower accounts for about 40% of defence production worldwide. Britain, Russia and France are the other big military suppliers, although they are much smaller than America.



Defence trade began to rise in the 1960s, after the American government set up a body called the International Logistics Negotiations (ILN) in 1961, designed to sell arms actively rather than wait for buyers to come along. The hard-up Labour government of Harold Wilson in Britain soon followed suit, hiring a former car-industry boss, Sir Donald Stokes from British Leyland, who used commercial sales techniques to improve Britain's success rate.

In principle, there is nothing wrong with selling arms abroad. It would be unreasonable to bar the defence industry from making use of its comparative advantage and reaping the benefits of trade. The British defence ministry, for example, spends around 13% of its procurement budget on co-operative-equipment programmes involving 19 nations, notably France, Germany and America. Likewise, without international trade Britain would have no modern nuclear missiles, and America no vertical take-off fighters.

Dirty dealings

The problem with arms exports is that they often go to unreliable governments in unstable parts of the world, with the deals smoothed by bribes. Defence companies rush to point out that they have codes of conduct against bribery and corruption, but they do hire local agents who labour under no such constraints. The American Department of Commerce reckons that half of all bribes paid in international business relate to arms deals, even though arms make up less than 1% of all trade.

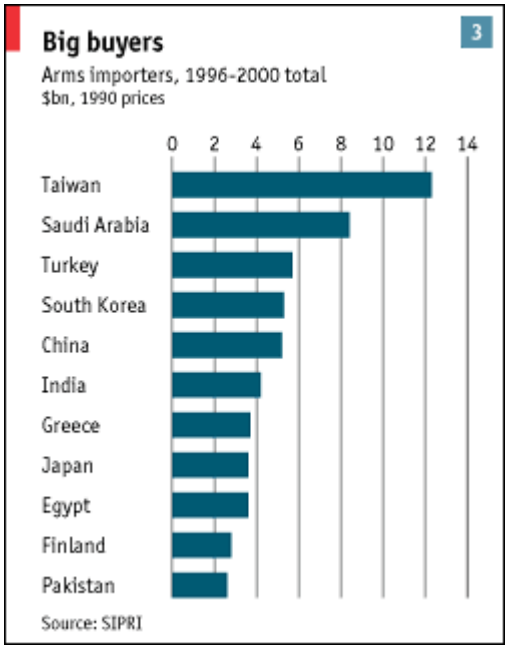
According to Laurence Cockcroft, chairman of the British arm of Transparency International, a body devoted to fighting corruption, there are several reasons why the defence industry is so susceptible to bribery and corruption. The details of arms deals are usually kept secret, on the grounds of export benefits and security concerns. In view of the slump in defence spending since the end of the cold war, export deals are often portrayed as vital for the survival of a company and the preservation of jobs. The deals are mostly large and involve high-value goods, making it easier to hide commission payments that finance bribes. And not everybody agrees that bribes are necessarily a bad thing: for example, in Britain they were not only legal but tax-deductible until last December.

Another factor is the widespread use of offset deals, which are agreements to give the buying country some of the work resulting from the order. This provides another opportunity for bribery, Mr Cockcroft found in a recent study. In one recent case South Africa bought British jet fighters, not because they were cheaper but because BAE Systems offered better offset terms. The deal was part of a large £3 billion defence contract which also involved German, Swedish and Italian suppliers.

The price of corruption

Corruption in defence procurement hurts the importing countries, where it wastes resources that would be better used for other purposes. It also undermines public confidence in politicians and institutions, destabilising the countries concerned or even whole regions, as happened in India and Pakistan. In January British ministers were in Delhi trying to sell fighters; only weeks later they were back pleading with India not to start a war with Pakistan. Only when 1m soldiers were facing each other across the border in Kashmir did the British government consider suspending arms sales. Britain's international development ministry has calculated that of the 40 poorest countries in the world, 24 are troubled by armed conflict or have just emerged from it. The weapons are rarely home-made.

But corruption poisons the exporting countries too. Leaving aside moral and legal arguments, bribes distort the market, adding to the price without adding to the value of a product. A company that keeps securing deals through bribes may become less and less competitive. Bribes also undermine a company's reputation. Lockheed Martin, America's biggest defence company (which Boeing dwarfs only when its civil business is added in), is particularly anxious to be seen as squeaky clean after being involved in bribery scandals in the 1970s and 1990s. “Nobody wants a contract that is going to sacrifice the reputation of our company,” a Lockheed manager told a recent conference on bribes and the arms trade.



The French company Thomson-CSF changed its name to Thales after being involved in a bribery scandal in Taiwan that ended up with the French foreign minister being convicted of corruption. Kickbacks persuaded the Taiwanese government to switch a contract for frigates from South Korea to France, doubling the price. The former German chancellor Helmut Kohl was another political victim, losing office after it transpired that an arms dealer had donated funds to the then ruling Christian Democrat Party after the government had approved the sale of tanks to Saudi Arabia.

Another, much larger, Saudi deal between the British and Saudi governments, known as the Al Yamamah contract, did much to keep BAE out of bankruptcy a decade ago. Under this deal BAE equips, trains and organises the Saudi air force in return for payment in oil (although the deal now seems to be winding down). An inquiry into the contract by the British National Audit Office in 1992 has never been published, contrary to usual practice, perhaps for fear of embarrassing the Saudis over the huge commissions involved. The British arms minister who had been lobbying for the deal, Jonathan Aitken, was subsequently jailed for perjuring himself in a libel action he brought against the *Guardian* after it wrote about a meeting between him and a Saudi middleman.

Two justifications are regularly trotted out for governments helping firms to export arms. One is that it promotes national strategic interests, acting as an extension of foreign policy. The other is that it is strategically helpful because it maintains the economic health of domestic defence companies. Both are nonsense. As Anthony Sampson put it in his book, “The Arms Bazaar in the 90s”, published in 1991: “The

speed with which Saddam (Hussein) had first built up his arsenal, and then turned it against his suppliers, made nonsense of the diplomats' justification for selling arms; that they are an extension of foreign policy which could bring influence to bear on the recipients, and that they could bring stability to unstable regimes." The behaviour of India and Pakistan also supports Mr Sampson's political point.

The economic argument is weak too. In a market economy, the whole concept of strategic industries is suspect. The European textile industry used to argue that it was strategic because armies need uniforms, but buying the kit from outside suppliers proves perfectly satisfactory. If defence companies went out of business, arms could be imported from allies. Over time, the net job losses would be negligible, as they proved to be in the run-down of heavy industries such as coal and steel in Europe. To take Britain as an example, arms sales there are worth about £5 billion a year, less than half of 1% of GDP. According to one academic assessment, government aid amounts to £400m a year. The industry employs about 90,000 people, barely 0.3% of the labour force. It is hard to believe that these jobs justify massive market distortions. But then defence is an industry like no other.

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Military revolutions

Jul 18th 2002
From The Economist print edition

Warfare meets the age of information technology

DEFENCE-INDUSTRY folk sometimes get nostalgic about the cold war. It is not only the huge military spending of the Reagan years that they miss, but also the sheer simplicity of life in those days. There was a clearly defined enemy. All that America had to do was keep its nuclear weapons in a state of readiness and maintain a quarter of a million men under arms in West Germany to face any Russian advance. Now America is down to fewer than 70,000 service personnel in Germany, the armed forces have been trimmed by one-third and the defence budget has shrunk by $100 billion. Europe has seen similar contractions.

Just like the movies

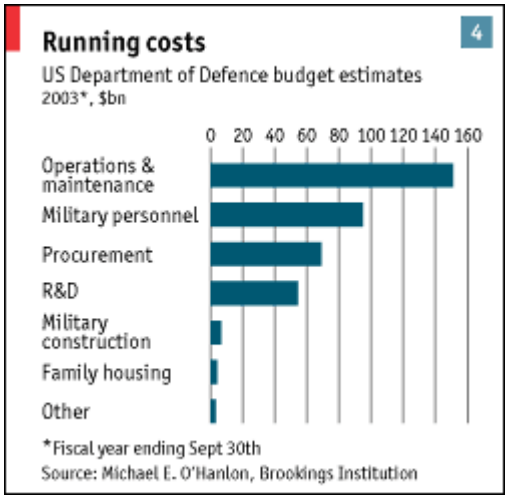
On both sides of the Atlantic, confusion about defence continues. Instead of a mighty visible enemy sitting on the far side of the German plains, there are terrorist groups such as al-Qaeda, and dangerous regimes such as Iraq or North Korea that might launch missile attacks or use chemical or biological weapons against America. September 11th showed America to be facing, in the words of one British diplomat, a “non-arrayed enemy”.

The Gulf war demonstrated the huge lead held by America and its allies in conventional warfare. Operation Desert Storm was a stunning display of American might. It provided various lessons, for example the powerful effect of precision-guided weapons such as cruise missiles. But around that time, too, military strategists began thinking about the emergence of threats from non-conventional, or asymmetric, warfare, such as a terrorist group attacking a nuclear plant or a rogue state using a biological weapon. “We've been working on asymmetric threats for ten years,” says Natalie Crawford, director of Project Air Force, a federally funded part of the RAND defence think-tank in Santa Monica.

The changing nature of the threat has been one reason why many military strategists, from America's commander-in-chief downwards, reckon that the world is currently in the middle of a “revolution in military affairs” (RMA). RAND defines an RMA as “a paradigm shift in the nature and conduct of military operations which either renders obsolete or irrelevant one or more core competencies in a dominant player, or creates one or more new core competencies in some dimension of warfare, or both.”

History has seen many such revolutions. One example is the English use of longbows, which ended the impregnability of mounted French knights in chain-mail armour. Others are the use of trains and telegraph by the Union army in the American civil

war, and the deployment of machineguns by the British to mow down Zulu rebels at the Battle of Ulundi in 1879. In modern times, General Heinz Guderian's blitzkrieg against Poland and then France qualified as an RMA: although all of its constituent parts—the battle tank, the bomber plane and the radio—had been used on their own before, the way they were deployed together amounted to a new strategy.



The other force driving today's RMA is the huge scope for military applications arising from digital and space technology. George Bush summed it up well in a speech in 1999, before he became president, pointing out that the American armed forces faced new thinking and hard choices: “Power is defined not by size but by mobility and swiftness.” The Afghanistan campaign, with its brilliant use of unmanned aircraft and precision-guided munitions (PGMs), such as low-tech bombs with a satellite navigation system bolted on to guide them to their target, has come to symbolise that change of emphasis. In the Gulf war PGMs made up under 10% of all munitions fired; in Afghanistan the figure was 90%.

For the past 100 years the main emphasis in military equipment has been on “platforms”, ie, the ships, aircraft or tanks that carry weapons. Now the platform is becoming less important than the network—an electronic web tying all weapons together to make the whole greater than the sum of its parts. Sir Timothy Garden, a defence consultant and a former assistant chief of Britain's defence staff, says that waging war in future will be similar to playing a video game. In the language of the Pentagon, “transformation” means getting from traditional platform warfare to this network-centric way of fighting.

Donald Rumsfeld, America's defence secretary, defending his latest budget before a Senate committee in May, explained why the American armed forces had to be transformed. On September 11th, he said, the nation “painfully learned” that its adversaries are changing. “They're watching us; they're studying how we were successfully attacked, how we responded. And they're looking for ways that we may be vulnerable in the future. And we stand still at our peril.”

In that spirit, Mr Rumsfeld cancelled the remaining $9 billion of a contract for the Crusader army artillery weapon, despite howls of protest from the army and from the manufacturers, United Defense International. Weighing in at over 40 tonnes, too heavy for most bridges and all but the biggest military transport aircraft, it was a weapon designed for old-fashioned conventional warfare, such as repelling a Soviet invasion of Germany. But modern wars are more like expeditions, and armies have to be able to move swiftly.

One reason why transformation is needed is that heavy casualties are unacceptable to American voters, as American politicians know. Another is that, to sustain a big war such as invading and occupying Iraq, America would run short of troops with its purely volunteer army, says Mr Sapolsky at MIT. It might need to re-introduce conscription, but under today's equal-opportunities regime that would include women, adding a further twist to the fear of casualties. However, his is a minority view. The official Pentagon line is that Iraq could be subdued, at a stretch.

The defence industry is scrambling to deliver what the military establishment wants in this new world. The buzz-word is C4IST, which stands for command, control, computers and communications, intelligence, surveillance and targeting—the heart of network-centric warfare.

Battlefield of the future

An example of the military future is on display in Anaheim, southern California. Since last September, Boeing's Battlefield Integration Centre (BIC), a fortified building on an industrial estate, has been visited by scores of Pentagon officials and military officers. Its centrepiece is a room like a cinema, with three giant screens along one wall and three control consoles below them. One screen has a satellite image of Korea with moving squares and triangles representing fighter jets, bombers and spy planes. Another has close-up pictures of trucks on the move, and a third has an image fed from a camera in a soldier's helmet.

This is a mock military operation, showing what warfare could soon be like. The screens display information fed digitally from sensors and cameras on aircraft, both manned and unmanned, from

satellite cameras and from infrared cameras on the ground. All the pieces of equipment are linked together electronically. The officer sitting at the control desk can home in on anything suspicious and put together a whole battle plan, lining up airborne and ground forces to attack the enemy.

Boeing's BIC gives a taste of the workings of an integrated command system that sucks up information from all available sources, including intelligence, and feeds it into a single database. It can make sense of huge quantities of raw data, using sophisticated algorithms to identify targets in order of priority and to calculate what is needed to destroy them. Boeing has won a contract to put together a real working version, known as the future combat system, for the American army. Northrop Grumman, a competitor, is expected to win a similar deal for the navy soon. The effect of such integration, says the CSBA's Andrew Krepinevich, is to apply concentrated fire-power from forces that are widely dispersed and therefore less vulnerable than traditionally deployed forces.

Some aspects of this information-age warfare are in place already. Whereas General Norman Schwarzkopf ran Desert Storm from a hastily built complex in Saudi Arabia, the Afghan war is being run by General Tommy Franks from the headquarters of Central Command in Florida. Video feeds from unmanned air vehicles (UAVs) have been relayed to President Bush in the White House. The idea is to have information about where everything is and where it is going, even to know how much your enemy knows, thus dispersing “the fog of war” and permitting rapid, efficient warfare. In Vietnam it took many bomber sorties to blow up one bridge; nowadays, a single missile is expected to do the job. Techno-centric warfare puts the emphasis not on armour but on information, explains Jim Albaugh, who runs Boeing's space and communications division. “Operations effectiveness increases up to tenfold,” he says.

The UAVs in Afghanistan point the way to the future. Northrop Grumman's Global Hawk, first used in Kosovo, proved its extraordinary range by flying from California to Australia before being used successfully on reconnaissance missions over Afghanistan. The Global Hawk is a “high-altitude long-endurance aircraft” (HALE), built on the scale of a medium-sized corporate jet, with a bulbous nose carrying its satellite antenna. It carries radar and two sets of sensors, electro-optical and infrared. Unlike some other UAVs, it is not piloted from the ground but operates autonomously. Its flight controls and navigation details are programmed in before take-off.

It was developed by Teledyne Ryan in San Diego, the company that built the Spirit of St Louis for Charles Lindbergh, bought by Northrop Grumman in 1999. The Global Hawk is designed to loiter over an area for 24 hours at 65,000 feet, thousands of miles from its base. Its height allows its sensors to cover a wide area. It also keeps it out of the way of fighters and bombers, and out of range of many missiles. Another UAV, the Predator, made by General Atomics, has been adapted so that in addition to its low-level reconnaissance role it can fire missiles.

The pace of development of UAVs is picking up, with more than $1.5 billion spent each year. In May Boeing broke new ground with a successful test flight of the first purpose-built UCAV (unmanned combat air vehicle). The X45A, as it is known, is a prototype of an unmanned UCAV designed to fly (with missiles) on extremely hazardous missions deep in enemy territory, to knock out air-defence installations such as radar sites and surface-to-air missiles. Another prototype, the X47A by Northrop Grumman, is due to start being tested soon.

Apart from dispensing with pilots, UAVs and UCAVs may cost only one-third as much as manned fighters to build, and their running costs might compare even more favourably. Enthusiasts such as John Warden, a former fighter pilot who helped plan the Gulf-war air campaign, reckon that by 2025 as many as 90% of all combat aircraft will be unmanned. The Pentagon dreams of whole ranges of such aircraft: silent fuel-cell-powered UAVs; hypersonic ones; super-smart ones that can identify an individual miles away; and enduring ones that can stay aloft for months.

The technical hurdles to be overcome include problems with keeping a number of UAVs in the air close together, and the huge amounts of bandwidth needed to guide them. Military planners had assumed that there would be plenty of commercial satellites in space available for them to use, but things did not turn out that way. Still, Northrop Grumman's Kent Kresa points to solutions such as the use of higher frequencies, data compression and laser links to satellites. He also expects more UAVs to be designed to operate autonomously.

Revolutions don't come cheap

In preparing for the transformation, Mr Rumsfeld and his colleagues started by redefining what America's

armed forces were for. Last October's Quadrennial Defence Review (QDR), for instance, overturned the previous vague strategy of having forces capable of fighting two overlapping wars on the scale of Desert Storm by setting six objectives: protecting the homeland and forces overseas; projecting and sustaining power in distant theatres; denying enemies sanctuary (ie, making it hard for them to hide from bombs and missiles); protecting the American information network from attack; using information technology to link American forces so they can fight jointly; and maintaining unhindered access to space as well as protecting Amerian space capabilities from enemy attack. To meet these objectives, the review increased the emphasis on missile defence, on general research and development and on joint-service training.

But the increase in the budget put forward in February, the first since the homeland terrorist attacks, did not match these grand ambitions. It provided for spending in 2003 to rise by $48 billion, to $379 billion. But much of the extra was earmarked for essentials such as military health care, pay rises and housing, with about $30 billion set aside to meet the cost of the Afghan war and the Pentagon's share of homeland-security measures. Further ahead, the budget is proposed to rise to $470 billion. If Congress approves these rises, the budget in real terms will return to its peaks of the Reagan years and, earlier, of Vietnam. But the economy has grown so much since then that, as a proportion of GDP, total defence spending will still be a lot smaller than in those days. Moreover, says Michael O'Hanlon, a defence expert at the Brookings Institution in Washington, the increase will go to maintain a military establishment that is still one-third smaller than during the cold war and that is not getting any important new weapons other than those already approved by the previous administration, apart from speeding up missile defence and accelerating development and acquisition of UAVs.

One reason for the rise is the administration's admission that previous defence plans, laid out in the 1997 QDR, did not allow sufficient funding for the programmes they contained. Another is that defence spending—be it on weapons, pensions, pay for IT specialists or dental care—tends to run ahead of general inflation. As Mr O'Hanlon spells out in a thoughtful critique of the defence budget, running costs are rising as a consequence of the “procurement holiday” during the Clinton years, thanks to which America's fighting ships, aircraft and artillery are all ageing and need lots of repair and maintenance. And such new weapons as were ordered, like the Joint Strike Fighter, never had enough money set aside for them, so that a growing “bow wave” of under-funded spending will reach the Pentagon as these weapons (mostly aircraft) start to be delivered after 2009.

Loren Thompson at the Lexington Institute says the Clinton era was the only time since 1950 when the allocation for weapons procurement fell below one-fifth of the defence budget. As a result, many bombers are 25 years old and the average tanker plane is 37. He reckons that under-provision for replacing ageing, worn-out equipment has caused a shortfall of 83% for armoured vehicles and of 86% for army helicopters. The navy fleet, which has already halved to 300 vessels, should be replaced at a rate of eight a year, but the current building rate is only five.

The Rumsfeld way out of this jam is to do things differently, taking advantage of RMA to transform the forces into light, agile organisations—which September 11th seemed to confirm as the right approach. Mr Thompson is unconvinced. To him, the talk of RMA that started in the Clinton years is about a “revolution in museum affairs”. He sees it as a ruse to distract attention from the lack of procurement, and thinks weapons-buying should be increased straight away.

Joel Johnson of the Aerospace Industries Association has a fair idea how the circle will be squared. “They won't do the (planned) numbers of aircraft such as the F22, the JSF and the F18,” he predicts. There is a growing consensus that in order to finance transformation without spending too much, the administration will make cuts in existing programmes. “The numbers always start high and then come down; it's the way it goes,” says Tassos Philippakos, a defence analyst at Moody's, a credit-rating agency. Candidates for trimming include the 3,000 JSFs, which could come down to 2,000, and the 339 F22s, which might be cut to 220. Projects such as the tilt-rotor V22 Osprey and the Comanche helicopter might be dropped altogether.

Mr Krepinevich thinks that before the Department of Defence can transform the armed forces it will have to transform the way it procures weapons, a system developed to cope with the relative certainties of the cold war. He reckons that the current “Wal-Mart approach”, in which the Pentagon orders large quantities of a fairly small range of new weapons systems to drive down unit costs, is unsuitable for today's uncertain times. His proposed remedy is to concentrate on systems integration rather than hardware. Encouragingly, that is precisely what seems to be happening, both in America and in Europe.

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An industry reinvents itself

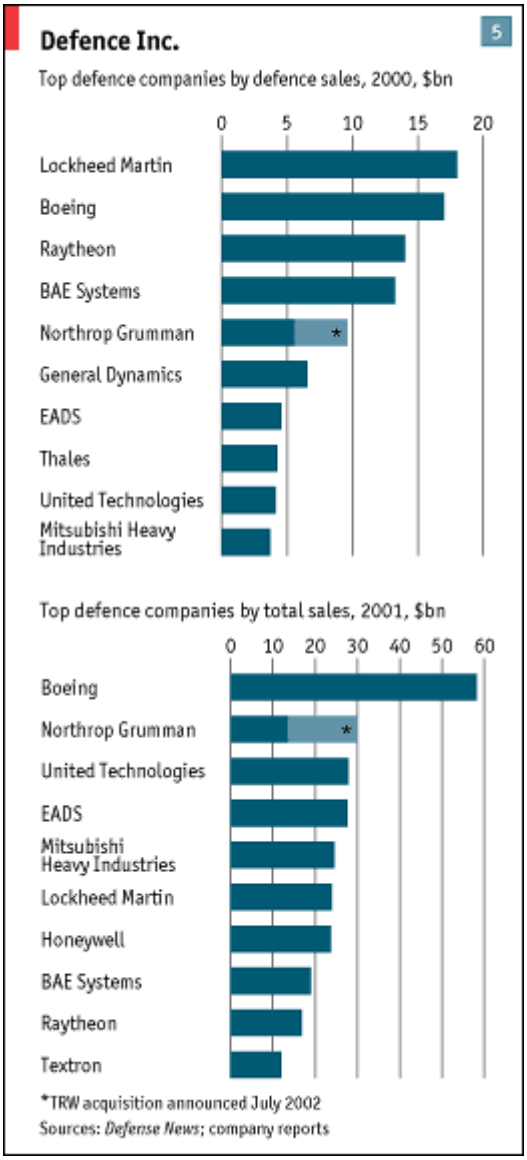
Jul 18th 2002
From The Economist print edition

America's defence companies are turning dual-purpose

THE 1990s were an eventful time for America's defence industry. With the cold war at an end, the number of big American contractors came down from 15 to five (Lockheed Martin, Boeing, Raytheon, Northrop Grumman and General Dynamics) within a decade. That was a dramatic consolidation, but as budgets shrank, it was not unexpected.

The other, more surprising development was that the defence industry turned into a kind of ghetto, despite considerable efforts to make doing business with the Pentagon easier and less bureaucratic. Barriers to entry were removed in the hope of turning defence into something more like a normal business, but instead of an influx of new blood, a mass exodus followed. IBM, General Motors, Ford, Chrysler, General Electric (except engines) and Texas Instruments all sold or closed their defence companies. As Merrill Lynch's Byron Callan put it, “The defence industry became detached from the rest of the economy.”

The reasons are not hard to find: the federal government is a demanding customer; defence profit margins are often tighter than in the private sector; and strict rules on procurement have in the past caused some defence companies to lose money on fixed-price development contracts. Many companies decided the defence game was not worth the candle.



With just a handful of big American companies and a trio of European ones, each of which dominates its home market and competes in places such as the Middle East and Asia, proper globalisation (in the sense of a number of transnational companies competing worldwide) seems out of the question. But that does not mean that globalisation will have no part in the defence industry at all. Because electronics and computing software play an increasing role in defence systems, the core defence companies have to ensure they have access to a wider pool of technology.

What remains to be seen over the next decade is whether the ghetto model will survive, or whether defence will eventually move closer to commercial business. The more it does, the more global it could get at the level of the second- or third-tier suppliers, who make components or equipment for the prime contractors. Lawrence Freedman of King's College, London, who has written on the implications of RMA, sees the ghetto walls coming down as the civil sector develops more technical dynamism. The trend towards increased use of IT and systems integration in warfare should accelerate this trend:

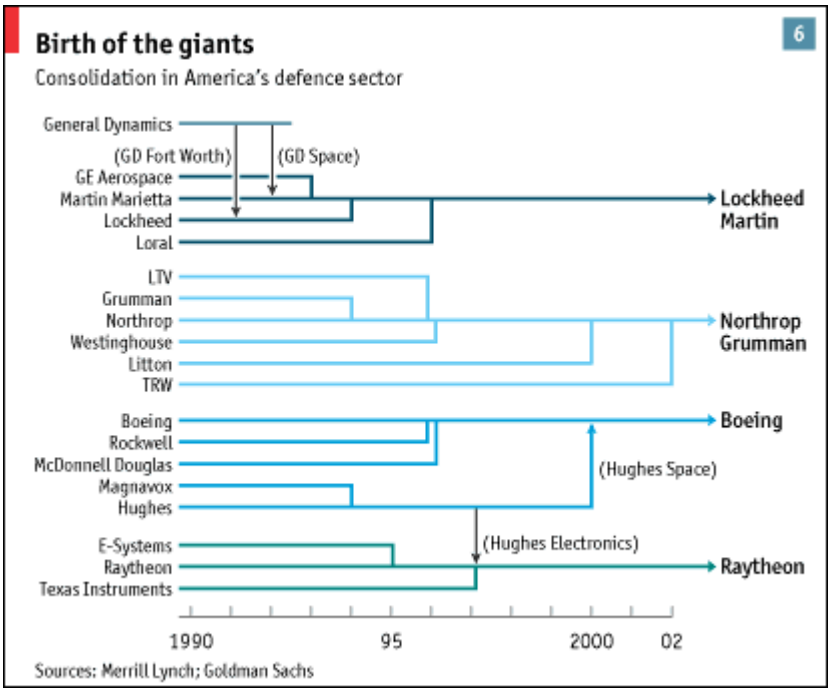
> The old defence sector was based on dedicated programmes with only a limited civilian spin-off. This now exists side by side with a more dynamic industry, which can pass through two generations of technology while the official defence-procurement machinery is still working its way laboriously through its bureaucratic mechanisms. Although the electronics and computing sectors originally took off on the back of military investment, they have now developed their civilian markets to such an extent that even the military is a minor player.

Underlying this is a worry that the defence industry, having consolidated so much with a loss of competition on both sides of the Atlantic, might begin to lag in innovation, and might not be up to supporting the transformation of the armed forces it serves. Even though America's military might and technology is streets ahead of anyone else's, the country cannot afford to be complacent. A recent study by RAND's National Defence Research Institute looked at military revolutions throughout history and found that, by and large, new ways of waging war were usually developed by a country or a group that was not dominant at the time.

Indeed, it could be argued that the most revolutionary military development to happen in recent times was the hijacking last September of four kerosene-laden jetliners to use as guided missiles in New York and Washington, DC. Modern electronic technology in the form of e-mails and the Internet played a big part in the planning of this venture.

By contrast, the traditional defence industry grinds away slowly, with mighty systems immutably determined by defence-department contracts. To take one example, the Joint Strike Fighter could well go into service with electronics systems that, although state-of-the-art in 2006, will be getting long in the tooth in 2012, unless something is done to update them.

Jerry Daniels at Boeing, which lost the JSF contract, points to the dangers that engineering teams will scatter and expertise will be lost when Lockheed Martin eventually becomes the only company making fighters. “Twenty years ago we had 50-odd defence contractors; today we have a handful. Then there were many rapid opportunities to bid, there was always a new programme coming along.” By contrast, he explains, the trend now is towards fighters that combine many functions and can be ordered in bulk. His (perhaps not entirely disinterested) suggestion is that it might be better to go for upgrades every five years and put the work out to competitive bids. To some extent, this is already being done. Boeing has recently won a contract to rethink and upgrade the avionics on the C130 transport plane manufactured by its arch-rival, Lockheed Martin.

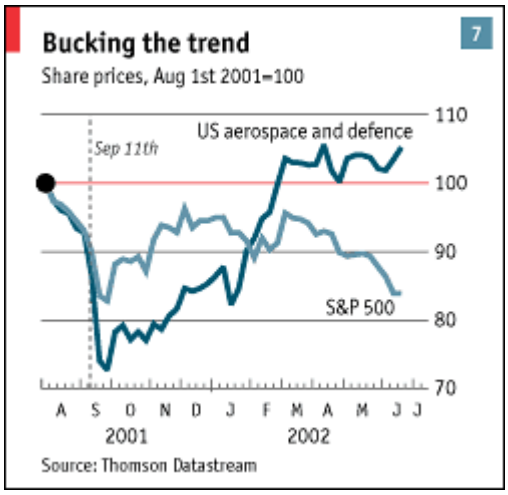


One reason why the defence department encouraged the mergers of the early and mid-1990s (see chart 6) was that it was worried about the financial health of the industry as budgets shrank. But by 1997, when a weak Northrop Grumman thought its best hope was to become part of the much larger Lockheed Martin, the government had had enough and blocked the merger on competition grounds. According to Pierre Chao of CSFB, an investment bank, the defence department then got into a panic about the collapse of defence shares as consolidation ended.

One concern in the Pentagon was that the defence contractors might have increasing trouble attracting capital and talent for which other high-tech firms are also competing. Mr Callan points out that a high-tech company such as Intel has a market capitalisation of over $100 billion, whereas the top three defence groups together add up to only half that. The concern is that top engineers will turn their back on defence companies and work for high-tech firms where they can make more money through stock options.

The irony is that Silicon Valley itself evolved from defence contracts, and that civilian jet aircraft, from the Boeing 707 to the jumbo jet, owed a great deal to military programmes. The same was true of computers. The defence industry pioneered the management of complex systems that have now become routine in civilian applications, such as air-traffic control or telecommunications. It is no accident that the world's leading (non-American) company in air-traffic control is Thales, a Paris-based defence-electronics company that specialises in dual-use technologies which can be applied to the commercial market.

According to Mr Krepinevich at the Centre for Strategy and Budgetary Assessment, the American government will have to improve its policy towards the defence industrial base if America is not to lose its technical lead. He thinks too much of what goes under the name of R&D is really devoted to the engineering and manufacturing development of incoming products. That may provide a nice cash cushion for companies, but it means they do little innovative research of the sort needed to develop entirely new products. He would like the Defence Department to take a hard look at future requirements to see which areas of technology could best meet them. Money for this could be found by chopping expenditure on mature technologies where extra R&D produces marginal gains.



Two-way traffic

Commercial input into the defence industry is not a one-way process. Leading defence companies such as Boeing, Lockheed Martin and Northrop Grumman have been changing their profile too, turning themselves into something more than makers of fighters, missiles and rockets. It is no longer simply technologies that spread from military to civil applications, as they did in the 1950s, when only the defence sector had big money to spend on R&D. Instead, the defence companies themselves are moving into the commercial field, using the expertise they have developed in the military sector.

An obvious example is Lockheed Martin, a conglomerate that three years ago was losing money and staggering under a debt burden of $12 billion. Integrating the various businesses from Lockheed's takeovers of companies such as Martin Marietta was proving difficult. Nothing was going right. The company's space rockets kept blowing up on the launch pad, the update of its C130J transport plane was hitting problem after problem, it lost a key satellite surveillance contract to Boeing, and losses kept piling up. Now it is climbing back into profit and has slashed more than $4 billion from its debt by selling parts of its business to BAE Systems, the British contractor which is becoming more American by the day (of which more in this article). Lockheed's shares look good largely because it beat Boeing for the JSF (F35) contract, which will ensure an inflow of billions of dollars even if the order is trimmed from 3,000 to 2,000. Its main partners in this deal are Northrop Grumman and BAE.

But there is more to Lockheed than big defence deals. About 30% of its sales are now in the civil sector (although admittedly civil work for the government far outweighs its private work). Lockheed buys in components and software from the electronics industry, but it is itself a huge IT company, employing some 20,000 systems and software engineers on top of its 50,000 mainstream scientists and engineers. The same “system of systems” needed for digital battlefields has commercial applications in organisations such as America's postal service, the FBI, Medicare and the Social Security system.

Boeing offers an even more striking instance of cross-fertilisation between the commercial and military sectors. It became big in defence when it bought McDonnell Douglas in 1996. McDonnell had put itself up for sale after it was excluded from the JSF competition in an earlier round, leaving Boeing and Lockheed in the final shoot-out. But Boeing had also acquired North American Rockwell with its space business, and later gained satellite expertise by buying parts of Hughes's electronics business.

Once Boeing's boss, Phil Condit, and his then number two, Harry Stonecipher (who had been McDonnell's last boss), had bedded down the mergers, they realised they were sitting on a collection of assets that could be used to sprout all sorts of businesses aside from jetliners, rockets and satellites. Using military technology, Boeing is developing so many new businesses in the commercial market that the share of its civil jet sales will soon fall from 60% of the group's turnover to around half. For instance, the same technology that guides missiles can be repackaged to provide satellite-based air-traffic management systems. And a military radar antenna is the key piece of kit in a system to bring broadband

communications to passengers in commercial jets.

The mergers have also made it easier for Boeing to ride out the loss of the JSF contract. Its space and communications division, based in Seal Beach, California, is the lead contractor working on America's national missile-defence system, as well as the provider of the future combat system that is part of the integrated battlespace system for the army. Like Lockheed, Boeing sees itself as an integrator of “systems of systems”. But these established giants face competition at the electronics-systems end of defence contracts.

Meanwhile, Northrop Grumman is still remaking itself. Its boss, Mr Kresa, says that Northrop saw the rundown in bomber production coming in the early 1990s and started to shift its emphasis to technology and systems. By acquiring Grumman, it got into the big JointStars aerial surveillance plane contract. With its purchase of Logicon, it got into information warfare. Brushing off the collapse of its planned merger with Lockheed Martin, Mr Kresa continued to build up the group. With Westinghouse, it bought electronics and radar; with Ryan, Global Hawk. Since then it has bought Litton Industries and Newport News to become the world's largest naval shipbuilder. It has successfully bid for TRW, an aerospace and car-parts group, against several competitors, including BAE. If the deal is approved, Northrop will sell off the cars-parts division and hold on to the missile and space business, which brings satellite know-how with it.

Other defence companies are still trying to clean up their acts. Raytheon, a missiles and radar group, is plugging on with reducing its huge debts by selling off some businesses, though its cashflow is still negative and its civil business-jet subsidiary is suffering. General Dynamics, which is big in ships, was blocked by the defence department in its bid for Newport News, which allowed Northrop Grumman to sweep up that firm. Northrop has also dealt General Dynamics a blow by winning a $2.9 billion contract to design the navy's new DDX destroyer, which is expected to be the basic platform for a range of ships that might produce contracts worth up to $60 billion.

The one newcomer that has dared venture into the defence ghetto is known as L-3 Communications, a company founded only five years ago by Frank Lanza, the former president of Loral, a defence outfit that merged into Lockheed Martin in 1996. Having supervised the integration, Mr Lanza persuaded Lockheed to sell him ten electronics companies. L-3 puts together guidance and intelligence devices. It enjoys revenues of $2.3 billion and is forecast to grow at 30% a year. It has also moved smartly into the newly burgeoning field of homeland security, with baggage screening devices and systems. Such civil business accounts for a quarter of its sales.

Despite some travails, Wall Street's glowing verdict on their shares gives a good indication of American defence companies' financial prospects. European companies, by contrast, face flat budgets and, except for the Anglo-American BAE, can hope to get little more than crumbs from the world's biggest defence market.

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Getting it together?

Jul 18th 2002
From The Economist print edition

Europe's defence companies cannot go it alone

EUROPE'S defence industry seems in a bad way. It is working in 15 fragmented markets, and largely excluded from America's huge and growing demand. Its customers are becoming less and less willing to spend. Its own research and development effort adds up to barely a fifth of what America invests. Seen from Washington, DC, the Europeans might as well give up and resign themselves to being subcontractors and junior partners to the powerful American companies, which need their help to sell in Europe.

AP

Will the A400M get off the ground?

Seen from Paris, Munich and London, the picture looks somewhat different. BAE Systems (formerly British Aerospace) sells more to the Department of Defence in Washington, DC, than to the defence ministry in London. By buying three American companies, BAE has made itself acceptable in the Pentagon. It owns Tracor and two other defence companies sold by Lockheed to reduce its debts, and is a risk-sharing partner in the Joint Strike Fighter. It also tried to acquire the defence and space parts of TRW, which recently fell to Northrop Grumman. BAE would never have been allowed into America like this had the American government not been keen to introduce some competition into the heavily concentrated domestic industry, and had it not trusted the British owner to behave responsibly.

“We didn't get to our position in America overnight,” says BAE's chairman, Sir Richard Evans. “We got there by being prepared to invest on the ground.” GEC's biggest subsidiary in America, Tracor, had been bought by GEC-Marconi, another British defence firm, before that merged with British Aerospace to create BAE Systems in January 1999. Ownership of Tracor was the main reason for BAE's decision to merge with the British defence company rather than with Germany's Dasa.

British defence companies (essentially, BAE, the engine maker Rolls-Royce and Racal) do far better than other Europeans in America, for the simple reason that in matters of defence the Americans trust the British more than they trust other foreigners. When he was assistant defence secretary in the Clinton administration, John Hamre, in an off-the-cuff but on-the-record speech, divided America's defence trading partners into three groups. The A group, as he called it, was made up of Britain and Norway; the B team took in France and Germany; and the C category contained Russia and China. According to Alex Ashbourne, a London-based defence consultant, this was never official policy, but it accurately reflects Pentagon thinking. At some point in every conversation with defence experts in America a Briton will be told, off the record, that: “Of course, you Brits are different.” The French are suspected of industrial espionage and lax export controls which Americans fear might allow sensitive technology to get into the wrong hands.

Special relationship

Mark Lorell and Julia Lowell, two RAND analysts who have been studying the international defence industry, have found it to be far less global than, say, the computer industry, because it lacks transnational companies. They have also found that such transatlantic trade and direct investment flows as there are in the industry mostly begin or end in Britain.

In recent years, America has relaxed export controls and other rules somewhat to make transatlantic joint ventures work more smoothly and to allow foreigners to own stakes in America's defence industry. But not a lot has changed. For example, BAE's subsidiaries are all lumped into one BAE America holding company, with special boards that exclude non-Americans. “There is a lot that goes on in our companies there on which information does not come to London,” says a senior BAE official. But Sir Richard has no problem with that: “We are in America because that is the big market, and it's growing.”

The other European defence heavyweights, European Aeronautics Defence and Space Company (EADS) and Thales, an international radar and communications company based in Paris, have little business in America, though EADS is to supply the US coastguard with helicopters. The European group has a few links with Lockheed Martin, and Thales has a joint venture with Raytheon and may embark on another with Northrop Grumman for a European version of its JointStars surveillance aircraft. Thales bought Britain's Racal defence-electronics company two years ago partly because it had business in America, and has been pressing its case in Washington, DC, in recent months, arguing that it is no typical French company. “We have half our business outside France, and half our sales are in civil business,” says its chairman, Denis Ranque.

The political case for transatlantic defence tie-ups was best summed up in a report a few years ago by Charles Grant, a defence expert and director of the Centre for European Reform, a London think-tank that manages to be both Atlanticist and Europhile. If the Americans and Europeans could collaborate rather than compete in defence technologies, Mr Grant wrote, it would be good for the Atlantic alliance and for world peace.

Co-operation also helps militarily by making joint operations easier if the two sides share the same technology, he argues. Rival transatlantic partnerships would replace protectionism with international competition, bringing the usual benefits of lower costs and better innovation. Transatlantic tie-ups would also help the Europeans upgrade their fighting ability by getting access to RMA technology, which they lack because they do not spend enough on R&D.

Transatlantic dreams

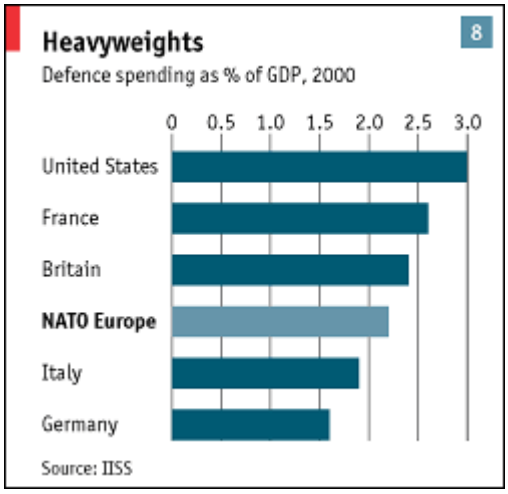
The Americans had less lofty aims in mind in the last few years of the Clinton administration. Mr Lorell at RAND says the starting point of the Clinton administration was worry about a growing “Fortress Europe” sentiment and the creation of a unified European defence industry. That was when the administration started pushing the idea of a global defence industry based on transatlantic partnerships.

America feared that lower exports would increase the cost of its arms purchases. Defence companies would seek to recover their lost export profits from their domestic sales, putting further strain on the shrunken defence budget. Europe buys about 20% of American arms exports, ahead of other big customers such as Japan, South Korea, Taiwan and Saudi Arabia, which America did not want as partners. If the Europeans were to enter partnerships with American companies, the thinking went, their governments would be helping to pay for the heavy development costs of new aircraft and missiles, such as an upgrade of the JointStars NATO ground target surveillance plane.

Partnerships would also remove unwelcome competition in third-country markets, which can generate a lot of ill-feeling when governments get involved. A current example is South Korea's decision to buy American F15 fighters instead of French Rafale models. Dassault, the maker of the Rafale, is challenging this in court, saying that the contest was swayed by purely political considerations. Since Dassault, through EADS, is part-owned by the French government, the scope for such rancour is obvious.

At the EADS headquarters in Munich, BAE and its boss are warmly spoken of. That may seem surprising, given that only three years ago the Germans were furious with BAE for casting them aside and

taking over GEC-Marconi instead. Yet over half of EADS's business is linked one way or another with BAE. Not least, on the civil side the British company owns 20% of Airbus, which accounts for over 60% of EADS's sales and most of its profits.



One explanation for the better climate may be that since BAE chose GEC-Marconi, the continental Europeans have got themselves organised through EADS. American defence-industry bosses understand that EADS, born in 1999 of the merger of Dasa (the aerospace wing of Daimler-Benz, now DaimlerChrysler) with the French Aerospatiale Matra group, could become a powerful company.

EADS has two big owners, each with about 30%: DaimlerChrysler, and a French holding company jointly owned by the government and the Lagardère conglomerate (former owners of Matra, a missile company). A further 30% is publicly traded on the Amsterdam stock exchange. In addition, a 5% stake is held by the Spanish government, a leftover from the Spanish CASA aerospace company being folded into Germany's Dasa before EADS was set up.

At first sight it looks a cumbersome company, with two chairmen, two chief executives and two head offices, to satisfy German and French national sensibilities. But, helped by the outstanding success of Airbus, it is becoming increasingly credible, despite rumours of internal bickering. Its profit margins and productivity in some sectors compare favourably with Boeing's.

Joel Johnson of the Aerospace Industry Association in Washington, DC, pays generous tribute to his colleagues across the water. “Let's face it, the Europeans have got 50% of the civil aerospace market. They have 60% of the space-launcher market. They have 50% of the commercial satellite business.” Although EADS in its early days has been heavily dependent on the Airbus civil aircraft, this could change dramatically, helped by the *euro*18 billion military transport programme known as the A400M. Despite endless wrangles in the German parliament over the number of aircraft the country's air force would order, the project may get its formal go-ahead very soon, possibly even next week at the Farnborough International Air Show.

Nick Fothergill, an aerospace analyst at Banc of America Securities in London, estimates that by 2004 defence will account for about 30% of EADS revenues and 40% of profit, up from 18% of both last year. He is not the only financial analyst to warm to EADS in recent months, despite the recent slump in orders for civil aircraft exacerbated by last September's attacks. It is not that Airbus seems to be faring better than Boeing in the depressed civil market, but the potential of EADS is becoming clearer. For instance, the Eurofighter programme is at last moving into the production phase, which will translate into solid revenues for EADS and its partners on the programme.

Americans are beginning to realise that the changes now in progress in Europe are not to their advantage. Europe may still be spending less on defence, and may still have a fragmented purchasing system. But now it also has joint programmes for military aircraft which make it less likely to buy American. The shadow of Airbus is beginning to fall over America's share of the European defence market, its biggest single export outlet.

When Europe was divided, the big American companies found it much easier to forge deals, product by product, with weak European manufacturers. These allowed for some local manufacture, which made it acceptable to buy American aircraft and missiles. But now that Europe has got EADS, the chances are that it will do in defence aerospace what it has already done in the commercial business with Airbus. Plainly this does not mean that Europeans will grab half the international defence-equipment market; that could never happen given America's geopolitical clout, and given the economies of scale the country reaps in its domestic market. All the same, the Americans are finding that the rules have changed: if they want to do defence business with France or Germany, they now have to involve EADS, and if they seek to sell in Britain, they now need BAE as a partner.

Transport tussles

For now, American anxiety is concentrated on the A400M transport programme. Fighters may be the most exciting and technically challenging aircraft, but at the moment troop-carrying transport aircraft

and in-flight refuelling tankers are hot items, almost as hot as UAVs. Recent regional conflicts from Kosovo to Afghanistan have demonstrated the importance of rapid deployment to difficult places far from military bases. That calls for transport planes to move the men, equipment and tankers to refuel the combat aircraft. For the transformed, agile armed forces that Mr Bush and Mr Rumsfeld seek, rapid transport is critical.

The existing fleet of such aircraft in both Europe and America is ancient, and the Americans even have incompatible re-fuelling systems for their air force and navy planes. RAF VC-10 tankers built in the 1960s had to be drafted in to help in Afghanistan because they use the same fuel-line docking system as the US navy.

For people such as Mr Johnson in Washington, DC, it makes no sense for Europe to spend around *euro*4 billion on developing a new military transporter. In his view, it could do very well with the existing American products, the venerable C130J (Hercules) from Lockheed and the big Boeing C17 for heavier loads such as tanks. If air-force bosses in Europe had a free choice, they would probably all opt for the two American offerings, not least because they are available now, and between them cover their needs, whereas the A400M will not appear for another five years. It has already been delayed so long that air forces have had to extend or renew leases on the American aircraft.

But it is not that simple. Sir Richard at BAE Systems points out that the C130J is too narrow for what the Europeans need. “You have to take helicopters apart to fit them in,” he says. Moreover, the various upgrades of this aircraft, designed 50 years ago, have run into problems, and it is more expensive than the new European A400M. Americans retort that Airbus has disguised the true cost of the A400M; they say it is much higher than the $85m per aircraft being touted. According to one industry source, by the time it has been adapted to have a roll-in-roll-out floor for quick-turnround missions, which Britain's Royal Air Force wants, the cost may be around $110m, only a bit less than the more capable C130J. So why not carry on with a mix of C130Js and Boeing C17s (now being sold at a discount), which between them carry the heaviest equipment and which the forces are geared up to use?

But the A400M's champions, such as Sir Richard at BAE Systems, see a huge potential export market for Airbus with this new aircraft. He thinks that economies of scale from producing it for most European air forces will make it an enticing product for export customers around the world. It is probably true that in this project military procurement is being used as an arm of industrial policy. An *euro*18 billion order will be handy for Airbus as it goes through a couple of lean years while the civil-airliner business recovers. Still, the Boeing tanker plane in America is being used in a similar way. At least in Europe the British are thinking about leasing Boeing's tankers, converted from wide-bodied jetliners.

Tom Enders, who runs the defence end of EADS, says the American objections to the A400M are exactly the same as those raised to the original Airbus civil aircraft 32 years ago, and recalls that Boeing itself considered joining the project a few years ago. According to Mr Enders, Boeing wanted to muscle in on a market dominated by Lockheed's C130J, and dropped out only when it became clear that American demand for an alternative to the Lockheed plane was a long way off.

The A400M is another attempt by the Europeans to get their act together on defence procurement. There has been some progress, for instance, with the co-operation that started in the 1970s and produced the Tornado fighter-bomber aircraft built by British Aerospace (as it then was) and Dasa in Germany, and sold to a number of European air forces. Its successor will be the Eurofighter, built by EADS and BAE systems, which is due for its first flight before the end of the year. But even these collaborative programmes are a long way short of total joint procurement by European NATO countries. For example, Europe still produces competing fighters—Gripen from Sweden and Rafale from France.

Over time, collaboration in European procurement and consequently in the industry will strengthen. Some senior managers at EADS think it would make sense for their company to acquire Thales, because that would put a platform-maker together with a defence-electronics company, in the same way that BAE became a fully rounded defence company with the acquisition of GEC-Marconi. But the politics of a Thales merger would be difficult. Mr Ranque seems strongly opposed to such a deal, and German managers at EADS are unenthusiastic about the French becoming the dominant partner.

Thales is making progress in America through its Racal arm, so acquiring it might help EADS overcome its biggest hurdle: its lack of political acceptability in the world's biggest defence market. Another way of tackling that obstacle would be to merge with BAE Systems, with which it already has a string of joint ventures covering most of EADS's business activities, ranging from Airbus to missiles and satellites. Failing such an ambitious deal, one of the greatest threats to EADS may be BAE's and Thales's

transatlantic links.

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A more commercial future

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From The Economist print edition

The defence industry should come out of its ghetto and join the outside world

THERE is a deeply gloomy view of the future that could lie ahead for America and its defence industry. It starts with the observation that RMA usually emerges from the underdog. It notes the 70% fall in procurement and the 25% fall in R&D since the peak of the cold war, and contrasts this with an explosion in R&D and technical advances in commercial industries such as electronics and IT. In the commercial sector, innovation rolls out new products in months, whereas in the bureaucratic world of defence it takes up to 18 years for a new weapons system to become reality.

> Over time all states—not just the and its allies—will share access to much of the technology underpinning the modern military...The strategic significance of global military-technology levelling cannot be overstated. It presents a great challenge to perhaps the fundamental, if subliminal, assumption underlying the modern—certainly post-cold-war—concept of military superiority: that the enjoys disproportionately greater access to advanced technology than its potential adversaries.

That view was put forward not by some obscure think-tank, but by the Defence Science Board in a report commissioned by the Pentagon in 1999. The board is a distinguished group of leading scientists involved in defence matters. Despite the alarming excerpt, the report by and large suggests that globalisation could be a good thing for American defence so long as the nation and the industry wake up to the opportunities as well as the threats.

Despite its distinguished credentials, the report is probably a bit over the top. It was commissioned, recalls Pierre Chao of CSFB, when the defence department was worried about the newly consolidated defence companies taking a battering; Lockheed Martin and Raytheon, for instance, suffered dramatic falls in their share prices. The consolidation, it was feared in the Pentagon, might weaken competition and innovation.

That fear led to a little opening-up. BAE was allowed to take over two more American companies and become part of the leading group of defence contractors alongside Lockheed Martin, Boeing, Raytheon, Northrop Grumman and General Dynamics. But it always had to be a team member or supplier, rarely the prime contractor responsible for delivering a whole programme.

One of the fears the DSB raised was of “levelling down”: the idea that since defence relies more and more on civilian technology, and since this is widely available, all nations will have access to the same technical resources for warfare. But considering that Japan, which has dominated world markets for consumer electronics and cars, is not capable of building a fighter plane without America's help, this seems a little far-fetched. Certainly the evidence on the ground, from the Gulf war through Kosovo to Afghanistan, confirms the impression that America's military capability is streets ahead of even its allies in Europe.

Semi-global

But although the defence industry itself will never become globalised in the sense of having transnational corporations and a free market, globalisation will affect it in a number of ways. One is the commercialisation of defence. As the Defence Science Board points out, there has been an explosion of R&D in commercial industries that sit alongside defence. For instance, microwave technology emerged from military applications, but is now commonplace in consumer appliances and telecoms equipment. Thales, which is a big developer of so-called dual-use technology, is a leader in battlefield radio communications as well as in-flight entertainment systems for jet airliners. These days, such entertainment systems sometimes feature more computer code than do fighter cockpits.

Many of the companies engaged in these industries have little interest in working directly with defence ministries, which are famously bureaucratic and difficult customers. The new leadership in the Pentagon, led by Donald Rumsfeld, has a strong business background, and is aware of the risks involved in the heavy consolidation in America's defence industry. They want to reform the Pentagon's acquisition process to speed up the adoption of new technology, and to encourage high-tech firms to get involved.

The best hope for innovation in defence, according to a recent RAND report by Mark Lorell, Julia Lowell and others, is through “Commercial-Military Integration” (CMI). The authors think that even without a deliberate Pentagon strategy, CMI will advance apace because of the sheer speed of technical advances in commercial sectors such as avionics and microwave devices. There is increasing sympathy for the view of Jerry Daniels at Boeing that equipment should be upgraded every five years or so. Having another source, say the authors, will help to keep the technology up to date and maintain some competition.

Globalisation is already affecting the defence industry in a number of ways. There has long been a tradition of partnership, as well as some local contracting to offset purchases from abroad. Mr Coffman points out that Lockheed deals with 300 partners in 62 countries, over half of them in Western Europe. The C130J alone involves 30 British companies. Another example is the JSF, where BAE is a risk-sharing partner in what looks like being the biggest defence programme ever. Nevertheless, Europe is still trying to work out its place in this industry. Perhaps the JSF involvement is as good as it gets.

America's superior spending on R&D and equipment will allow it to pull further ahead in the development of network-centric warfare, which involves hugely sophisticated systems integration. Europe has pockets of excellence that it would be wise to exploit, but there is no doubt that America will continue to dominate the defence industry. The grim new mood after September 11th, and the loosening of purse-strings it has brought with it, will make sure of that. Moreover, America is less inclined to share defence secrets now than it was ten years ago.

Those who say that defence spending in America will soon fall back, as it did after the Reagan peak, are wrong. Spending had been on a cyclical dip even before the collapse of the Soviet Union in the early 1990s. This time round, says CSFB's Mr Chao, it was on the up even before the terrorist attacks. So the boost that will come from the political support for higher budgets is coming on top of a cyclical turn, taking it on to a higher level. Defence is back, as it were, with a vengeance.

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Corporate reform

Clambering back up

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Can Americans trust their business leaders to do the right thing?

AFTER the race to the bottom, a race back up to the top. Claiming a desire to “help restore confidence in corporate America”, on July 14th Coca-Cola announced that it would begin recording employee stock options as an expense on its income statement. A day later, the Washington Post Company said that it too would make the change. AMB Property, a hitherto obscure real-estate investment firm, said that it had been expensing options for a whole week already, throwing doubt on Coca-Cola's stated willingness to “take the lead on this issue”. More firms might follow these pioneers, including Heinz, a food group, and Delta Air Lines.

Give Coca-Cola its due: its timing is spot on. Twice in two weeks, President George Bush has demanded that corporate America put its house in order. On July 16th Alan Greenspan took his turn to wag his finger at America's bosses. Too many of them, said Mr Greenspan, had sought ways to “harvest” the booming stockmarket of the late 1990s. The investments of ordinary Americans, meanwhile, keep wilting. Since the start of the year, the S&P 500 index has fallen by over 20%.

Coca-Cola's choice of reform is also clever. Although other initiatives are beginning to take shape in Congress, efforts to make it compulsory to charge the cost of stock options as an expense have fallen foul of the high-tech business lobby. That has turned options-expensing into a pressing issue among those Americans who feel their government is doing too little.

The willingness of companies to embrace this accounting change voluntarily, meanwhile, cheers free marketeers. They urge caution in new rule-making and claim that the system can, by and large, be relied upon to fix itself.

Dice men

On the evidence so far, who is right? One place to look for the answer is bosses' pay. The theory is that the huge amounts of stock options dished out to executives in the 1990s encouraged them to behave badly. Unlike stock itself, a stock option has no downside: the owner might gain a lot of money if his company's share price rises, but he loses only the cost of the option if the share price falls (and nothing at all if the option is given to him). That might have encouraged excessive risk-taking at the top—a willingness, as Ira Kay of Watson Wyatt, a pay consultancy, puts it, to “roll the dice”.

Combined with the freedom to sell the company's stock once the option is exercised, stock options might also have encouraged short-term business strategies, or even fraud. By fiddling with their accounts,

company bosses could hope to drive up the share price, cash in their options, and set sail in their yachts.

Stock options are indeed becoming less popular in the boardroom. Mr Kay sees a gradual switch from options to outright share-ownership plans. So does Peter Chingos of William Mercer, another consultancy. Mr Chingos says that efforts to make bosses hold on to their companies' shares are also gaining ground. New share-ownership plans, for instance, might typically prevent the boss from selling his shares for five years. Sanford Weill, the boss of Citigroup, boasts of the “blood oath” that he and the company's other executives must take. As long as they run the company, Citi's top dogs must keep three-quarters of any shares or options that they receive. Between them, Citigroup's board of directors and senior managers own 85m shares, worth a staggering $3.2 billion.

There is a happy coincidence at work here. Because of the slumping stockmarket, options were in any case becoming less popular. Chief executives already have their drawers full of worthless options. Increasingly, they prefer straight shares, says Mr Chingos, because even if the market falls, shares are still worth something.

Stock-holding restrictions, meanwhile, typically lack bite. Few companies can match Mr Weill's blood oath. Much more typical are rules requiring chief executives to own company shares worth, say, six times their annual salary.

Another test of reform is the way companies choose to present their accounts. Here, shareholders are demanding more “honest” numbers, designed to illuminate, rather than disguise, the profitability of businesses. The decision by Coca-Cola, AMB and others to expense stock options is the first big sign that companies are beginning to take these calls seriously.

Employee stock options are not a huge cost at Coca-Cola, however. By the company's own calculation, expensing them would have knocked just $200m off its profits in 2001. West-coast technology companies, such as Microsoft and Cisco, will find it harder to follow suit. Cisco, for instance, calculates that the options it dished out to its employees last year had a value of $1.7 billion. The Business Roundtable, a trade organisation for chief executives, remains opposed to options-expensing, on the dubious argument that there are so many ways to calculate their cost. Elsewhere, “pro forma” accounting—the selective (and usually flattering) removal of certain costs in calculating “core” profits—remains far too common.

Ban the boss

A final test of reform is change in the boardroom. One effort has been to strengthen outside directors as a counterweight to over-mighty bosses. As part of the proposed changes to its listing requirements, the New York Stock Exchange (NYSE) wants to make boardroom “executive sessions” without the chief executive compulsory, a change that corporate-governance activists think might help to restore some balance to the board.

It was thought that these executive sessions would arouse controversy. As it turns out, chief executives have put up little resistance, says Leon Panetta, a former White House chief of staff who sits on the NYSE's board. Given the news, he chuckles, bosses are not in much of a position to complain. David Nygren of Mercer Delta, a consultancy, thinks this change could help to entrench the role of a “lead” independent director, America's answer to the separation of the role of chairman and chief executive that has already happened in many British companies.

Supporters of greater government intervention might argue that these achievements are slender. But several points are worth bearing in mind. It is still too early to tell how far companies are willing to go. Cynics will say they are playing the same waiting game as the politicians. The economy could recover, the markets might bounce back and America might invade Iraq. All three events would lessen the impetus for reform. But America's capricious shareholders, whom bosses serve, might also change their minds, and once again stop caring about greedy bosses. After all, a couple of years ago, none of this mattered to them. “We have sought leadership in corporate governance for years,” says Hamid Moghadam, the boss of AMB. “Nobody noticed until a month or two ago. All of a sudden, everybody cares.”

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Newspapers

Street fight

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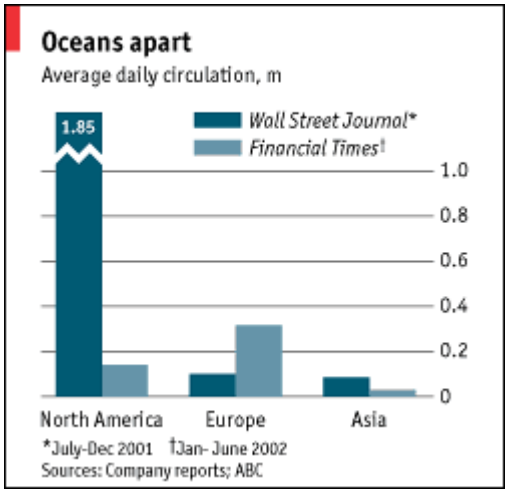
The Wall Street Journal and the Financial Times slug it out



WHEN the *Wall Street Journal* and the *Financial Times*, each facing a flat home market, stepped up the quest for new readers abroad, they were bound to collide. Within weeks of each other in February 2000, the *Journal* relaunched its Europe edition, with colour splashed across its front page and a supplement dedicated to the "new economy", and the *FT* unveiled *Financial Times Deutschland*, a new German-language title. Now that the market has turned sour, however, their contest is throwing up some harsh choices.

While each paper chases the same English-speaking international business reader, and each has thrown a lot of money at its online version, they have followed quite different print models. The *Journal* runs three different editions, each with its own editor, regional headquarters and name—the *Wall Street Journal*, the *Wall Street Journal Europe* and the *Asian Wall Street Journal.* Each paper closely tailors its content to the region. The *FT*, by contrast, which is owned by Pearson, part-owner of *The Economist*, is a global title, edited in London, with only about 15% of the content varying by region. In Europe its strategy has been to complement the *FT* with in-house local-language publications: *FT Deutschland* in Germany, *Les Echos* in France, *Expansion* in Spain.

Now, however, the severe advertising downturn is putting pressure on both strategies. In the first six months of this year, advertising revenues at the *Journal*'s international editions were 36% down on the same period of 2001. Ad revenues at the *FT* fell by 25% in the first half of the year from the same period of 2001, according to an estimate by Merrill Lynch, after dropping by 20% in 2001 as a whole.

The *Journal* maintains that it needs its vast army of journalists, but they are costly to support. It can call upon around 1,600 reporters for its print and online editions worldwide, next to some 500 at the *FT*. In continental Europe the *Journal*'s circulation growth has been healthy. Yet the Europe edition has been profitable for only three of the past five years. Efforts are under way to streamline the overall structure. Earlier this month Dow Jones, the *Journal*'s parent, moved Karen Elliot House from her job as head of the non-American editions to publisher of all editions, including the American one.

Ms House's move, coupled with the recent firing of a handful of reporters in Europe, has created deep unease among the edition's journalists, who worry that they have lost their sponsor. (Ms House is married to Peter Kann, chairman and chief executive of Dow Jones.) Ms House dismisses such fears as "ludicrous", and says that there is "not one iota of consideration" being given to closing the European edition, nor to *Handelsblatt*, the German daily paper that jointly owns the *Journal* in Europe, pulling out—a rumour that *Handelsblatt* also denies.

Just as the *Journal*'s European troubles stem in part from its bid to trample on the *FT*'s territory, so the *FT*'s difficulties come partly from its effort to march into the *Journal*'s patch. The *FT* has more than quadrupled its circulation in America since 1997, to 140,000. But it still only nibbles at the heels of the *Journal*, which has a North American circulation of 1.85m (see chart). The *FT* claims that it cannot meaningfully calculate whether its American edition is making any money.

The trouble is that the *FT* has not yet secured enough circulation there to tempt many regional advertisers. Only about 10% of its ad sales in America are for the domestic edition only, according to Olivier Fleurot, the paper's managing director. As one global media buyer puts it: "If you were targeting

a campaign in the US, you couldn't do it in the *FT* alone."

Andrew Gowers, the *FT*'s editor, refers to his newspaper's American drive as "our core mission: not an option we can switch on and off." Yet he too is under pressure to cut costs. Already, he has closed *The Business*, a weekend supplement in the *FT*, and put on hold a plan to launch an Asian edition. Some even question whether *FT Deutschland*, the centrepiece of the *FT*'s strategy in Europe, is vulnerable. While the title has built up a claimed circulation of 82,500 amid fierce German competition, it has not yet made a cent. But just as questions about the future of the *Journal*'s international editions go to the heart of that paper's global strategy, so would any attempt to touch *FT Deutschland* undermine that of the *FT*.

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About sponsorship

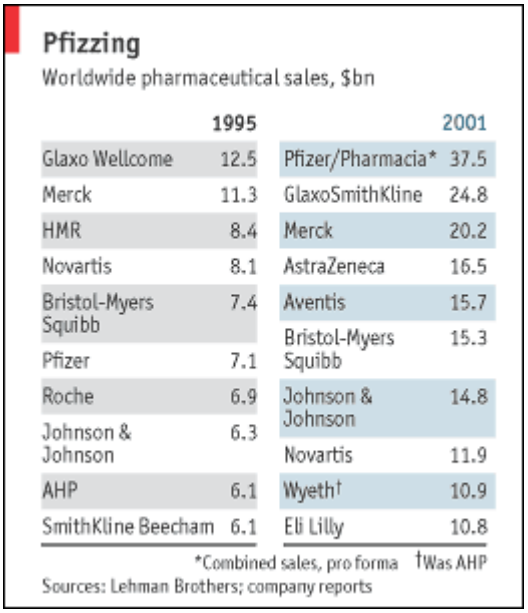
Pfizer and Pharmacia

Mating and waiting

Jul 18th 2002
From The Economist print edition

The industry leader breaks away from the pack. But the price is steep

LIKE physics, the pharmaceutical business follows the laws of nature. To boost their profit growth, companies can either add mass or speed their sales of home-grown products ever upwards. This week Pfizer opted for mass, announcing that it would buy Pharmacia, a smaller rival, in an all-share deal worth $60 billion.



The acquisition will make Pfizer the world's largest pharmaceutical company by far, with combined sales of around $48 billion, 30,000 sales reps worldwide and an annual research and development (R&D) budget of over $7 billion. It will also become the first company in recent history to hold more than 10% of the global market for drugs.

Even before the merger, Pfizer was massive, one of the industry's big two, along with GlaxoSmithKline (GSK). So why buy Pharmacia? In a word: Celebrex, its bestselling drug for inflammation. Pfizer already had a stake in the fortunes of Celebrex, through a co-marketing deal with Monsanto-Searle, its original developer. That partnership continued when Pharmacia bought Monsanto in 2000. Last year Celebrex brought the two firms $3.1 billion in sales. By buying Pharmacia, Pfizer also takes control of a few other lucrative products, such as Xalatan, a treatment for glaucoma, giving it a dozen drugs with annual sales of more than $1 billion.

This is not the first time that Pfizer has proved to be the Victor Kayam of the industry, liking a product enough to buy the company. When the company launched a successful hostile bid for Warner-Lambert, another American drug producer, in 2000, the prize it sought was Warner-Lambert's Lipitor, a blockbuster cholesterol-lowering drug.

As the smaller partner in the merger, Pharmacia's employees are understandably nervous that most of the $2.5 billion in annual cost savings expected by 2005 will come from their side. But Hank McKinnell, Pfizer's chief executive, says he sees more in Pharmacia than just Celebrex—for instance, interesting opportunities in the firm's R&D pipeline of cancer drugs, and a salesforce that is well-trained in selling to specialists. (Pfizer's sales strengths lie mainly in marketing to general practitioners.)

That alone does not explain why Pfizer is paying 44% over Pharmacia's share price—minus Monsanto, which will be spun off later this year—at a time when investors are hyper-sceptical about mergers. Thomas Foster of Cambridge Pharma Consultancy argues that the deal buys Pfizer some breathing-space. On its own, the firm's late-stage drug pipeline was not enough to maintain the high double-digit profit growth that investors have come to expect. The addition of Pharmacia's products and pipeline will help to keep up the profit momentum through an otherwise rough patch starting around 2005.

This week's deal is expected to set off another round of mergers in the industry. As Sir Richard Sykes, former chairman of GSK, points out, almost all the big firms are caught in the same bind of stalled productivity, patent expiries and pricing pressure. Some smaller firms, such as Schering-Plough and Abbott, may have little choice but to find a partner. Some of the bigger ones, such as Novartis, are known to be shopping around.

The biggest question of all is whether GSK, burdened by patent worries, will try to catch up with Pfizer.

Jean-Pierre Garnier, its chief executive, says his firm already has everything it needs to be a great success when new products start coming through the pipeline in a couple of years' time. Whether GSK's shareholders will prove as patient, or wander off to Pfizer, remains to be seen.

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German television

How far down can you dumb?

Jul 18th 2002 | FRANKFURT
From The Economist print edition

Neun Live is trying to make cheesy interactive television pay

SEVERAL hundred euros can be yours, explains the presenter for the umpteenth time. Simply call and name, first, this programme and, second, the fictitious boxer played by Sylvester Stallone. For viewers who find this hard, the letters “R. Balboa” are in the corner of the screen. Welcome to Neun Live.

The “Dance Marathon” dream

When media moguls first dreamt up interactive television, they had in mind a marriage of the personal computer and the TV set. But it has so far been more low-tech, relying mostly on the old-fashioned telephone: call and win, or call and buy. From the calls and the sales, the theory runs, there is money to be made. The chief exponent of the art is QVC's Barry Diller, now chairman of Vivendi's Universal Entertainment division. He is also the owner, indirectly, of almost half of Neun Live, a German station that used to trade as tm3. Most of the rest belongs to ProSiebenSat.1, a (solvent) part of the bankrupt Kirch empire.

Christiane zu Salm, Neun Live's managing director and a former MTV executive, says that when she took over the station last year she knew she could not rely on advertising to make it pay. So she turned to the telephone “because people know it; they have learnt it.” She calls the genre “impulse television”. The impulses include the chance not only to win money but also to book holidays. In one recent two-and-a-half hour show, says Ms zu Salm, the station shifted holidays worth *euro*440,000.

With call revenues accounting for about half Neun Live's income, the channel is in essence “a mini-telecommunications company with an attached television station”, says Ms zu Salm. Those hoping to win money pay around 50 cents per call, of which the channel gets half. There is an “impulse” for the presenters, too: the more calls during their stint, the higher their pay. Callers get discounts if they ring more than 100 times. Ms zu Salm says Neun Live needs 11m-12m calls a month to cover its costs. After 10.3m in April, the station received 17.2m in May and 16m in June. Only a handful get through to the presenter.

Neun Live's mixture of mind-numbing games, travel and sex enjoys high-profile input. A recent top offering, “Dance Marathon”, was dreamed up by John de Mol, creator of “Big Brother”, after seeing the film “They Shoot Horses, Don't They?”. Couples danced for 19 hours out of every 24. The last pair standing staggered home with *euro*100,000. The money-winning slots on the programme attracted 200,000 calls an evening.

Not everything Neun Live shows is quite so jaw-droppingly inane. It has aired reruns of “MASH”, and recently started screening “Dynasty”, a 1980s money-and-shoulder-pads soap. You aren't supposed to watch, though, but to call into a quiz with cash prizes. So who played Alexis, then? Hint: Joan C*ll*ns.

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Airbus

Bettering Boeing

Jul 18th 2002 | TOULOUSE
From The Economist print edition

Europe's Airbus could outpace its American arch-rival next year

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Reuters

Nosing ahead

THE big question at the Farnborough International Air Show, which opens on July 22nd, is: will Boeing announce one of the biggest-ever aircraft orders, worth $12 billion at list prices, or will Airbus grab part of the deal? The buyer is easyJet, a fast-expanding low-cost carrier. EasyJet, which is taking over another low-cost airline, Go, is set to order 120 new aircraft, with options to buy a further 120. Although the deal is worth $12 billion on paper, in practice such plum orders come with big discounts.

EasyJet's board has met several times to discuss the order in recent days, suggesting that there is little to choose between Airbus and Boeing, and that the order might be split between the two. Low-cost carriers such as easyJet and Ryanair will account for over half of the 400-450 jetliner orders expected this year, because they are the only airlines prospering in the current aviation slump. Boeing has had a stranglehold on the low-cost market ever since its 737s were first used by Southwest, the original American no-frills carrier.

The rationale for easyJet splitting its order lies partly in its purchase of Go, which had already said that it was in exclusive negotiations with Airbus, presumably on very favourable terms. Moreover, Stelios Haji-Ioannou, easyJet's founder, is having second thoughts about relying solely on the 737; he has said that the economies of scale from a single model begin to fade as a fleet grows. EasyJet may just choose to use roomier Airbus A319s for business traffic, while keeping more fuel-efficient Boeings on its leisure routes.

So far this year, Boeing is leading with a net 134 orders against Airbus's 104. However, Airbus's chief executive, Noel Forgeard, reckons that his share by value is 52%, because the Toulouse-based manufacturer has sold more big jets.

As Airbus crept up from a third of total orders ten years ago to match Boeing, the American company kept emphasising that what really counts is deliveries, not orders, because that is when cash is actually paid for aircraft. Until recently Boeing had two-thirds of the market by this measure. But that is about to change. Airbus, with over 300 aircraft ordered for delivery in 2003, is likely to produce more than Boeing, which expects to make 275-300 (in aircraft manufacturing, production and delivery figures are usually identical).

The collapse in the market for civil jets has been more traumatic for Boeing, which has had to slash output and lay off 30,000 workers. Airbus has only had to postpone plans to raise production by 50% and cut back on overtime. Privately, Boeing executives accuse Airbus of building planes that have not been ordered. Airbus denies this.

Although orders from low-cost carriers will dominate the market this year, this may change once the market recovers. Airbus reckons that, between 2006 and 2012, mainstream flag carriers will account for 67% of the market, compared with only 13% for low-cost airlines. The real money, it reckons, is in bigger aircraft, such as its new super-jumbo, the A380. Buoyed by the confirmation this week of Fedex's order for ten A380s, Mr Forgeard predicts that he will have two more Asian customers (including Japan Airlines, the biggest user of Boeing 747 jumbo jets) within the next 12 months. Airbus, he says, is in the

“dream position” of having, counting options, 80% of the 250 orders it needs to make money on the A380. Such confidence.

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Economist.com BUSINESS
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E-commerce

Identity rules

Jul 18th 2002 | NEW YORK
From The Economist print edition

Internet standards can no longer be written by technology firms alone

WHEN an industry group called Liberty Alliance announced specifications for how to manage “digital identities” on July 15th, it was hardly headline-grabbing stuff. Yet the event may prove important in the history of the computer industry, by marking the beginning not only of an ID system for the digital world, but also of an era in which standards are no longer set mainly by the companies that sell information technology.

Knowing who a user is has traditionally been left to individual websites or software applications. Consumers and company employees tend to have many different identities in the form of passwords and user names. But multiple identities are becoming a serious drawback for e-commerce. Consumers forget their passwords and spend their money offline. Firms fail to purge former employees from their directories, giving them the opportunity to wreak digital havoc.

One basic way to unify digital identities is known as single sign-on. These services let a user—whether a consumer or a company employee or supplier—move seamlessly from one website to the next without having to retype a password. The holy grail, however, is technology that allows businesses to manage identities—and thus risk—in exactly the same way as they do offline, says Jamie Lewis, chief executive of the Burton Group, a consultancy.

Technology firms have lined up to get a piece of the identity pie. Seven of them—including Novell and Sun Microsystems—have announced products that comply with Liberty Alliance's specification. For its part, Microsoft, which is not a member of Liberty, had hoped that its single sign-on service, called Passport, and a related set of offerings, called My Services, would become the main attraction of its .NET software platform for web services.

Although the technology was innovative, Microsoft got the politics wrong. It had planned to build a centralised system in which it would hold identities on behalf of consumers. But airlines, banks and others began to worry that this would drive a wedge between them and their customers—so Microsoft now also offers software that will allow clients to run their own identity services.

This shift in strategy came too late to stop a counter-movement in the form of Liberty. The consortium was launched last September by Sun, Microsoft's arch-rival. The idea was that instead of having a central identity provider, multiple accounts would be linked. For instance, a user could buy a plane ticket online and then book a hire car without having to sign on again and retype the destination.

Liberty could have turned out to be just another cartel, cobbled together to neutralise the advantage of the market leader. But the group, which now has more than 60 members, has turned out to be something different: a web-standards body driven by large users (rather than providers) of technology. Its chairman is Eric Dean, chief information officer of United Airlines. Firms such as United got involved mainly because they did not want to get caught in another standards war that would force them to support competing technologies. Anthony Scott, General Motors' chief technology officer, predicts that large companies will increasingly insist that IT vendors stick with common technical rules.

But there is something more important at work, says William Guttman, an economics professor at Carnegie Mellon University. Increasingly, he argues, standards are not there only to regulate IT; they

must also take account of public-policy issues, such as privacy. Without the input of users, government and academics, as well as technology firms and their corporate clients, specifications risk being irrelevant.

Allowing for broad input, however, does not guarantee success. On the contrary, reaching agreement is likely to be harder. The first version of Liberty's specification deals only with single sign-on, not with the more controversial exchange of user information, such as payment details and buying preferences. What is more, Microsoft and IBM, which has also decided to stay out of the consortium for now, may yet try to launch a competing standard.

On top of this, consumers might not bite. So far, they are not very enthusiastic about identity services. Most register with websites only because they have to, and do not trust technology firms to prevent misuse of personal information. Promoters of identity services will probably have to face the fact that many, if not most, consumers will prefer to stay anonymous—just as they can in the offline world.

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Japanese corporate restructuring

Uncut

Jul 18th 2002 | TOKYO
From The Economist print edition

Lots of layoff announcements, but not much action

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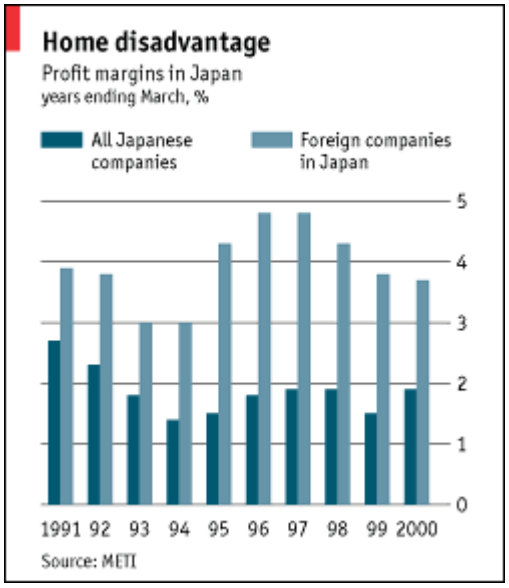

JAPAN'S slow progress with restructuring continues to frustrate investors. Although signs of a cyclical upturn have appeared, an economy that lurches forward only when exports sputter to life does not inspire confidence—especially since companies expect their domestic sales to grow by only 1% this year. Of course, businesses all over Europe and North America find ways to boost profitability without revenues soaring, by cutting costs and boosting the efficiency of their use of assets. That may be why foreign investors make decent money even in Japan's stale economy (see chart). But despite a sharp rise last year in press articles mentioning *risutora*, few Japanese companies are yet restructuring in earnest.

Start with the most obvious source of inefficiency: bloated workforces. The excitement of last autumn stemmed from a series of huge layoff announcements by Japanese firms. These included plans by electronics giants such as Fujitsu, Hitachi and Toshiba to unload tens of thousands of workers apiece. To gauge whether any of these cuts will prove real and lasting, Garry Evans, chief Japan strategist for HSBC, a British bank, went back and looked at the previous big *risutora* wave, in 1998-99, when even bigger layoffs were announced. These job cuts were usually pitched as two-to-three-year plans. Some—notably those pushed by Nissan after France's Renault bought the car maker—have followed through. Yet overall, fewer than half of the companies involved have come even close to their promises.

Many fudged the cuts by hiding workers the way Enron hid debts. They created new, unlisted subsidiaries and hived workers off the parent's books without cutting the group's labour costs. Mr Evans was able to keep track of this because of changes in Japanese accounting rules, which now require firms to file consolidated reports for subsidiaries they control. But he worries that in the recent wave of layoff announcements, companies have learned a new trick. By creating 50-50 joint ventures, which neither side controls, they can play the same games all over again.

The worst part, however, is that managers refuse to restructure capital assets and narrow their focus even more stubbornly than they resist job cuts. Robert Feldman, chief economist at Morgan Stanley's Tokyo office, points out that, by boosting profit margins a little, the half-hearted job cuts announced in 1998 helped to nudge up returns on assets, from 2% to 2.6% over the past three years. By contrast, Japanese firms have been unable to boost the revenues they earn from a fixed amount of assets, the other way to raise returns.

To do this, argues Mr Feldman, firms must carve up their sprawling businesses, become more focused and learn to treat capital as a precious resource. One source of trouble is the banks' failure to force dud firms out of business. In sectors such as retailing, still overcrowded despite a series of bankruptcies, the zombies' ability to cling on prevents the kind of asset-shuffling that could generate new industry structures. Slowly, some competitive pressures are filtering through. Mr Feldman reckons that Nissan's cost cuts, for instance, put pressure on its suppliers, forcing some healthy consolidation on the steel industry.

If capital markets fail to wake up the rest of Japan's companies, China's growing clout, and the deflationary pressures it is sending across Asia, could eventually trigger the bigger changes they need. For all the headlines devoted to investments in China, such as Honda's announcement last week that it will begin making cars there, too few Japanese firms have moved plants overseas to cut costs.

Goldman Sachs reckons that pressure to do this could begin to build quite soon. It expects Japan's perennial current-account surplus—which rose to ¥1.04 trillion ($8.3 billion) in May, according to figures published this week—to erode sharply before long, perhaps disappearing altogether within five years, forcing Japanese firms to respond more to global pressures. Both the United States in the 1980s and Germany in the 1990s (following unification) began to boost their returns on equity shortly after their current-account balances swung negative. It takes a great deal of pain to get Japanese companies to change their ways; but more pain may be exactly what many of them are in for.

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Face value

Auf wiedersehen, Ron

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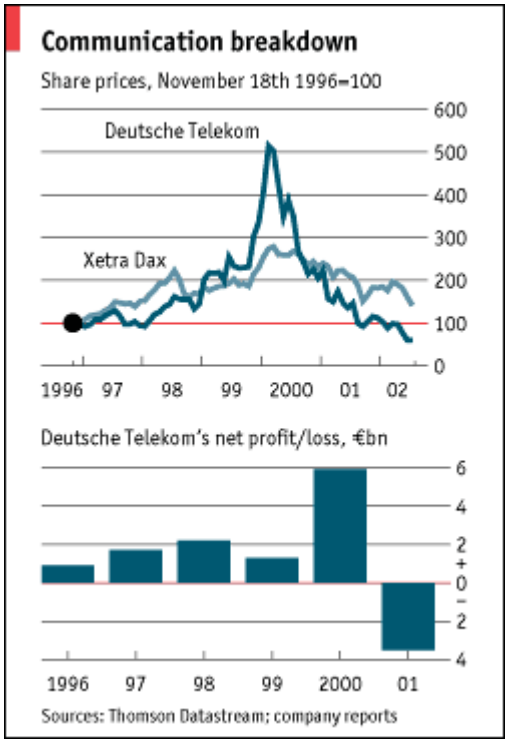
From The Economist print edition

Deutsche Telekom may not do much better without Ron Sommer

NEVER let it be said that Ron Sommer lacks drive. He got his first job after striking up a conversation with Heinz Nixdorf, a German computer entrepreneur, on an aeroplane. So impressed was Mr Nixdorf that he hired the cocky youngster, who was running Nixdorf's French operation by the age of 27. Years later, when he was interviewed for the chief executive's job at Deutsche Telekom, he wowed the board by speaking fluently, without notes, about the future of telecoms—a business he had never worked in. He was, it was said, the only candidate the board took seriously.

But although drive may get you places, it is not always enough to keep you there. This week, after seven years running Deutsche Telekom, Europe's biggest telecoms group and Germany's corporate flagship, Mr Sommer was ousted. He is the latest victim of the purges sweeping through the industry, which have already claimed the top men's scalps at WorldCom, Qwest and BT (see article).

Mr Sommer's exit was no surprise. He had been under pressure to go for weeks, mainly from Telekom's largest shareholder, the German government, which has a 43% stake. With a tight election coming up in September, Chancellor Gerhard Schröder was worried that bad news at Telekom would hurt his chances. Its shares have fallen by 90% from their peak, and they are now below the level at which the government sold a first tranche in 1996 (see chart). Telekom posted a loss of *euro*3.5 billion ($3.1 billion) last year. The government barely bothered to conceal its plan to oust Mr Sommer. In the end, he was as much a victim of politics as of the capital markets.



One way to see Mr Sommer is as the German equivalent of Jean-Marie Messier, who ran France's Vivendi until he was pushed out a fortnight ago. Both became corporate icons in their own countries, symbols of a new, more professional order in business. Mr Sommer became synonymous with Germany's new equity culture after Telekom's landmark flotation, and today 3m Germans own shares in the firm. Both men took stodgy utilities and sought to turn them into global "new-economy" powerhouses. But both overreached, and ran up big debts that ultimately toppled them.

The parallels do not end there. Neither Mr Sommer nor Mr Messier was greatly burdened by self-doubt. Mr Messier was happy with his moniker J6M, ending "master of the world". Mr Sommer, though less overtly arrogant, treated the media and analysts alike with disdain. Within Telekom he was autocratic: in one infamous incident, several top managers at T-Online, the Internet arm, including its boss, resigned after they had failed to persuade Mr Sommer to relax his grip on the subsidiary. Even right at the end, after it became clear that he had lost the board's confidence, he hung on, insisting that he had made no big mistakes.

Not quite true. Like so many other telecoms bosses, he got carried away in the boom. He spent more than *euro*11 billion on 3G mobile-phone licences in Germany alone, and *euro*80 billion on a

series of generously priced acquisitions. Chief among these was the *euro*33 billion purchase of VoiceStream, America's sixth-biggest mobile operator, at the height of the boom. To cap it all, Mr Sommer launched an ill-advised bid for Telecom Italia, Italy's incumbent, in an attempt to keep it out of Olivetti's clutches. Deutsche Telekom was beaten back after the Italian government sided with Olivetti.

Marketing-minded

There was, however, much that Mr Sommer got right. Tanned and suave, he understood the importance of marketing. Today, in contrast to when he took over, Telekom has a strong brand, and not just in Germany. He introduced a service culture—no mean feat when over a third of your employees are civil servants and so unsackable. He was also good at playing both sides of an argument. He skilfully managed to lay off over 100,000 workers without losing the support of the unions; last week, 23,000 employees signed a petition calling for him to stay. Nor is Telekom's debt pile of *euro*67 billion entirely his fault. It would be much lower had German regulators not blocked divestments, such as the *euro*5.5 billion sale of Telekom's German cable assets—and if Telekom had not been forced to carry the costs of rewiring the former East Germany.

It is hard to see how booting out Mr Sommer leaves Telekom any better off, at least in the short term. The government's meddling has ensured that no high-profile business figure wants his job. It had hoped that the board would give the position to Gerd Tenzer, the colourless head of Telekom's networks division. Instead, the supervisory board picked Helmut Sihler, its 72-year-old former chairman, to be a caretaker chief executive for up to six months, with Mr Tenzer as his deputy. The financial markets reacted nervously.

With good reason: the last thing Telekom needs now is more drift. It is perhaps in better shape than France Telecom, whose boss, Michel Bon, may soon go the same way as Mr Sommer. Nor can the German government let the company go bust. But the longer Telekom takes to deal with its debt problem, the further it will slip down the list of telecoms survivors. A rights issue may be unavoidable.

The most pressing operational problem is VoiceStream, which is bleeding cash. Possible buyers include AT&T Wireless and Cingular. Although Mr Sihler has hinted that a quick sale may be in the offing, he will be lucky to get a third of what Mr Sommer paid for it. But as the cocksure Mr Sommer would no doubt never have put it, beggars can't be choosers.

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The telecoms crisis

Too many debts; too few calls

Jul 18th 2002
From The Economist print edition

The telecoms industry is in a mess. What went wrong, and how can it be fixed?

THE bigger they are, the harder they fall. And in recent times nothing has got much bigger, or fallen much harder, than the telecoms industry. WorldCom, a disgraced industry giant embroiled in an accounting scandal, teeters on the verge of bankruptcy. Its collapse, were it to happen, would be the biggest in corporate history. But it would also be only the latest in a line of telecoms firms to have gone under.

WorldCom is currently subject to a criminal investigation, as is Qwest, another American telecoms giant. But telecoms firms untainted by scandal are also struggling to service their huge debts. Banks' global exposure to the industry is estimated at $1 trillion, according to Ovum, a consultancy. Some analysts reckon that as much as half of that may yet have to be written off.

Telecoms share prices have plunged and chief executives are being steadily booted out. This week it was the turn of Ron Sommer, the boss of Deutsche Telekom, who was forced to resign on July 16th. But the job losses extend far beyond the boardroom. Telecoms operators and equipment vendors have laid off nearly 500,000 people in America alone since the beginning of last year, according to figures from Challenger, Gray & Christmas, a firm of headhunters.

The dotcom crash, it turns out, was merely the warm-up. The telecoms crash is many times bigger. Michael Powell, chairman of America's Federal Communications Commission (FCC), surprised nobody when he declared this week that the industry is facing “utter crisis”. The situation is being likened to the Dark Ages. The old empires have fallen and a prolonged period of uncertainty looms. How did telecoms companies get into such a hole, and how can they climb out of it?

Fallacious foundations

Now that the crash has happened, there is no shortage of theories to explain it. The simple one is that too many firms got caught up in Internet mania, assumed astronomic rates of traffic growth and, egged on by bullish investors, started building networks to carry that traffic. The trouble is, this construction boom was founded on a number of fallacies.

The first, says Allan Tumolillo, an analyst at Probe Research and a long-time telecoms sceptic, was the old saw of “build it and they will come”. Alas, they did build it—but they did not come. Since 1997, Internet traffic has roughly doubled every year. But much of the industry was betting on it doubling every 100 days (see article). This mythical growth rate was then expected to apply to all forms of

telecoms traffic. And what better way to prepare for the coming deluge than to lay vast amounts of fibre-optic cable?

This was a big mistake. Between 1998 and 2001, says Andrew Odlyzko, a researcher at the University of Minnesota, the amount of fibre in the ground increased fivefold. Meanwhile, advances in the technology of feeding signals into fibres at one end and extracting them at the other increased the transmission capacity of each strand of fibre 100-fold. So total transmission capacity increased 500-fold. But over the same period, demand merely quadrupled.

To be fair, when digging up the ground and laying fibre, it makes sense to lay far more than is currently needed. If you are laying 24 strands, you may as well lay 240. The problem was not that individual firms laid too much fibre, but that there were so many firms building almost identical networks. In the United States, more than a dozen national fibre backbones were constructed; a similar duplication happened in Western Europe.

The second destructive fallacy, says Mr Tumolillo, was the almost ritual invocation of Metcalfe's Law, a finding from computer science which states that the number of possible cross-connections (and hence the usefulness of a network) is proportional to the square of the number of nodes or users. This was used to justify the building of enormous pan-European or global networks, on the basis that bigger is exponentially better. But the real world is more complicated than computer science, notes Mr Tumolillo. When two American telecoms firms, SBC and Ameritech, merged in 1999, the combined firms' network became larger, but the value of the merged firm still fell.

A third myth is the notion of “Internet time”, which Mr Odlyzko defines as “the perception that product development and consumer acceptance were now occurring in a fraction of the traditional time.” He does not dispute that the Internet is a significant advance in communications technology, and he admits that 100% annual growth in traffic is not to be sniffed at. But, he says, new technologies take many years to diffuse, and the Internet is no exception. Telecoms firms, however, were betting on an overnight transformation that would translate into a sudden leap in demand.

As upstart firms splurged on vast infrastructure investments, the incumbents followed suit. The former national monopolies in Europe, AT&T in America and NTT in Japan all tried to transform themselves into global operators. They built new networks and bought stakes in foreign operators. European companies gambled that the supposed surge in demand for fixed communications capacity would be followed by a similar leap in demand for mobile capacity, and they paid over *euro*100 billion ($90 billion) for licences to run “third-generation” (3G) mobile networks. In the process, they ran up huge debts.

When it became clear that the industry had bet on an increase in demand that was not likely to materialise in the near future, ferocious competition and frantic price-cutting ensued. Equipment vendors' sales dried up. And some firms resorted to fiddling to conceal the lack of revenue.

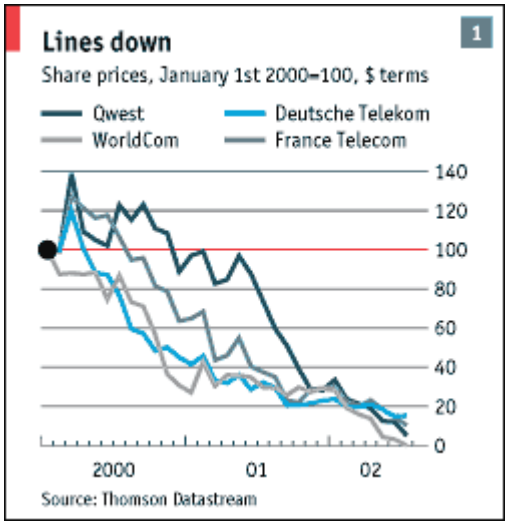
After the party

The industry's hangover has two components: overcapacity and debt. If it is to recover, it must tackle these two closely intertwined problems. When an operator goes bankrupt, its capacity does not go away. Instead, the new owner (or the original owner, operating under bankruptcy protection) can run the network far more cheaply, having been freed from much of the need to service the debts incurred in building it. The result is a domino effect: prices fall, driving other tottering operators into bankruptcy. If WorldCom fails to reach agreement with its creditors over its $32 billion of debt and seeks the protection of Chapter 11, it may well drag other firms with it.

By contrast, former national monopolies (such as France Telecom and Deutsche Telekom) can be sure that their governments will stand behind them. It is inconceivable that either would be allowed to fail. But they still have to do something about their debts: France Telecom owes *euro*60 billion; Deutsche Telekom almost *euro*70 billion. Both will have to sell assets, retrench in their home base, and raise new money from the capital markets.

Of Europe's former national monopolies, British Telecom has led the way in pursuing this kind of debt-reduction strategy. By spinning off O2, its wireless arm, selling minority stakes in

overseas operators and launching a rights issue, it has reduced its debts from around £30 billion ($47 billion) to less than £14 billion over the past 18 months. It has also replaced its senior management team—a step that other telecoms firms will want to take to restore investor confidence. For this is the industry's greatest challenge. Only when confidence has been restored, balance sheets are cleaned up and new management put in place can the next phase of the revival begin: a massive round of consolidation. Given the current fragile state of stockmarkets, this is still some way off.



Widespread consolidation seems likely to happen first in mobile telecoms. A shake-out in America's fragmented wireless market is long overdue and will probably centre around the sale of VoiceStream, the country's sixth-largest mobile operator, which Deutsche Telekom bought last year for *euro*33 billion. In Europe, Vodafone is expected to buy SFR, a French mobile operator, from Vivendi, a struggling conglomerate. (Vodafone paid for acquisitions during the boom with its own shares, so it is relatively low in debts.) And O2 looks like an acquisition target, with its most likely partners being Spain's Telefonica Moviles or Italy's TIM.

The bigger question is what will happen to America's struggling backbone operators, such as WorldCom, Qwest and Level 3. One of these might absorb its weaker rivals and emerge victorious. But how would it pay for such a consolidation? Last week, a group of investors including Warren Buffett of Berkshire Hathaway, a long-time telecoms sceptic, invested $500m in Level 3, which will use the money to fund acquisitions. This was taken by some as a sign that the consolidation game had begun. But $100m will not buy much, even in today's markets. “This is not a sign of the market turning,” says Morgan Stanley's Alok Sama.

The last left standing

Another possibility, which inched closer this week, is that one of America's Baby Bells—Verizon, SBC and Bell South, which operate local-phone networks—might be allowed to buy WorldCom. The FCC's Mr Powell has signalled that he would consider allowing such a deal, even though antitrust barriers at present stop the Baby Bells from fully entering the long-distance market. He told the *Wall Street Journal* that the antitrust implications of relaxing this rule would have to be balanced against the potential disruption that would ensue if WorldCom were forced to shut down.

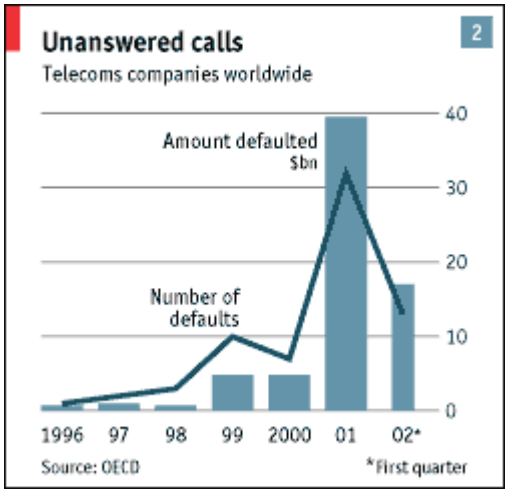
Amid the turmoil, the local operators—the Baby Bells in America, and the former national monopolies in Europe—are now seen as relatively safe havens. They own the “last mile” of the network that runs into homes and offices, and this local monopoly gives them a firm grip on their customers and solid revenues. SBC makes much of its stability: on its website the firm declares that it is “prepared to accommodate new customers looking for dependable, reliable voice and data services during the current uncertainty in the telecommunications industry.”

The local operators are certain to be among the last left standing. And even with assets selling at knock-down prices, they are currently the only buyers. If the upstarts are taken over by the local operators (or just vanish), the telecoms industry could end up looking much as it did before the liberalisation of the 1990s.

In both Europe and America, the local operators have close ties with wireless firms, and are doing their best to establish new monopolies in broadband Internet access. Admittedly, they face competition in this area from cable companies. But it looks increasingly likely that, from the current turmoil, the local operators will emerge in the industry's driving seat. This poses a challenge for regulators. The local operators will argue for a lighter regulatory touch, given the industry's crisis. But a concentration of power in the hands of fewer companies implies a need for stronger, not lighter, regulation.

This month a consortium of European telecoms firms, all of which

compete with former monopoly incumbents, complained to the EU's competition commission that the incumbents are engaged in "methodological anti-competitive behaviour" by refusing to open up their local networks to competitors. Mario Monti, the EU's competition commissioner, who is already investigating France Telecom and Deutsche Telekom for discriminating against would-be competitors, said he might soon launch further investigations. It has long been clear that the incumbents' unspoken strategy is to be as obstructive as possible in opening up the local network to competitors, in the hope that these rivals all go bust before the incumbents are forced to let them in.



What will pick the telecoms industry up off the floor? Eventually, the problem of overcapacity will be overcome and supply and demand will be brought back into line. But only then will equipment sales start to pick up. The few analysts prepared to speculate about when this might happen talk vaguely about 2004.

There is no shortage of traffic growth. Internet traffic is (reliably) said to be doubling every year, and voice traffic on both fixed and mobile networks is rising. But as the industry has found to its cost, traffic growth does not translate into revenue growth. Moreover, in the rich world at least, markets are saturated. So new revenue cannot come from new subscribers either, which is what has recently fuelled the mobile-phone industry. Instead, it will have to come from new services for which customers are prepared to pay.

What might such services be? On fixed networks, operators are betting on network-management services for large firms and broadband connections for consumers. Telecoms operators, says Henry Elkington of the Boston Consulting Group, find themselves in a similar position to America's transcontinental railways in the 19th century. Having built high-capacity networks, they need to find new ways to drum up valuable new forms of traffic. The railway firms sold land and transported immigrants in order to generate freight traffic. The incumbent telecoms operators are not renowned for their ability to deliver innovative new services. "The challenge is to move from a single-product utility to selling 100 different applications," says Mr Elkington.

The mobile industry faces the same challenge. The idea behind 3G was that new data services, delivered to whizzy phones with colour screens, would provide new revenue for operators, to compensate for falling revenue from voice calls. But nobody knows what kind of services consumers really want. The current best bet, based on the runaway popularity of text messaging (which now accounts for 14% of European operators' revenues) is that consumers will pay extra to zap photos between camera-equipped phones, a service that is already popular in Japan. After that, the industry has high hopes that customers will fork out to play electronic games with each other while on the move.

But the lesson of the past few years is that the industry is notoriously bad at gauging demand for its services. The two most successful new telecommunications technologies of the past decade—Internet access on fixed networks, and text messaging on mobile networks—were both unexpected breakthroughs that emerged in spite of, rather than because of, the industry's best efforts. So, once the smoke has cleared and the dust settled, expect the telecoms revival to come riding on the back of an unexpected technology that nobody in the industry has yet heard of.

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Internet traffic

The power of WorldCom's puff

Jul 18th 2002
From The Economist print edition

Exaggerated figures for Internet traffic inflated the telecoms bubble

IT WAS an essential ingredient of dotcom business plans and conference slide-shows: Internet traffic, went the industry's favourite statistic, doubles every 100 days. The claim assumed unimpeachable status when it appeared in a report published by America's Department of Commerce in April 1998. Unfortunately for the telecoms firms that rushed to build networks to carry the reported surge in traffic, it wasn't true.

So where did the claim come from? According to Andrew Odlyzko, a former researcher at AT&T who is now at the University of Minnesota, the short answer is WorldCom. Every time that Mr Odlyzko tried to trace the claim to its source, he says, he was always “pointed at folks from WorldCom”, typically Bernie Ebbers, its recently departed chief executive, or John Sidgmore, his replacement. The claim in the Department of Commerce's report, for example, is attributed to UUNET, WorldCom's Internet subsidiary. As the world's largest carrier of Internet traffic, UUNET was assumed to know the numbers.

To be fair, says Mr Odlyzko, Internet traffic did grow this quickly in 1995 and 1996, when the Internet first went mainstream. But since then, he estimates, annual growth has settled down at around 70-150%, a far cry from the 700-1,500% trumpeted by WorldCom. The myth of 100-day doubling, however, refused to die. In a press release from 1997 WorldCom referred to traffic “almost doubling every quarter”. At a conference in 1998, Mr Sidgmore's presentation included graphs that referred to 1,000% annual growth. In fact, he was referring to the growth of network capacity, not network traffic. But it was widely assumed that traffic was growing just as fast. WorldCom executives made similar claims in interviews published in 2000.

Rival telecoms companies believed the myth and cited UUNET's figures, even if their own traffic figures disagreed. That just meant their salesmen were not selling capacity fast enough. Mr Odlyzko recalls meetings at AT&T where his claims that growth was actually far slower were dismissed. Instead, he was told, “we just have to try harder to match those growth rates and catch up with WorldCom.” Companies such as Global Crossing and Qwest soon resorted to “hollow swaps” and other dubious tricks to boost sales and traffic figures. Meanwhile, shares in Internet companies soared, and the telecoms industry engaged in an orgy of network construction in preparation for a deluge that never came. WorldCom executives, says Mr Odlyzko, are thus “more responsible for inflating the Internet bubble than anyone.”

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Stockmarkets in America and Europe

Stop this dream

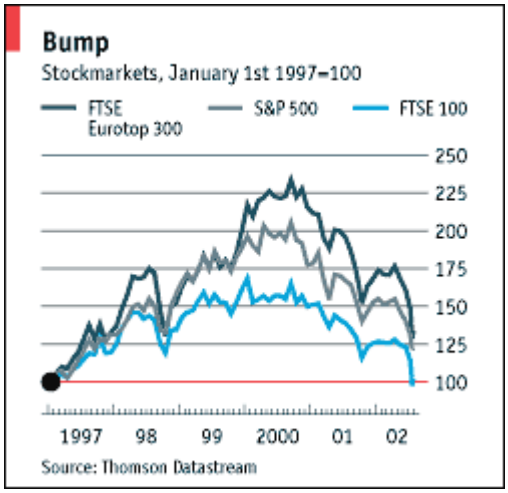
Jul 18th 2002
From The Economist print edition

Corbis

Might stockmarkets still have a lot further to fall?

CHEER up: a point will come when share-price falls on both sides of the Atlantic are no longer warranted by the calculation of future returns from those shares. And, all can agree, that point is now closer. For over a week until July 16th, American markets fell almost every day, and Europe followed or fell even more.

America's S&P 500 index has now shed 20% this year and 40% of its value since its peak in March 2000 (see chart). London's FTSE 100 index is also down by 40% from its peak in December 1999, retracing six years of gains. The FTSE Eurotop 300 index of continental European shares has fallen by 45%. Connoisseurs of manias, panics and crashes talk of a stage of capitulation in every bubble's bursting, when investors abandon hope that share prices will ever find a floor. With hairdressers and out-of-work actors now losing sleep—and calling their brokers in the morning—has the moment of capitulation come?



Not yet. Put aside for now the effect on share prices of what the chairman of the Federal Reserve, Alan Greenspan, this week called the “infectious greed” of executives and shareholders—a greed that has done much to knock confidence in the system of capitalism itself. Even without those doubts, share prices in America, though much less so in Europe, are still out of line with what the economy is likely to deliver in the coming years.

How far out depends on your assumptions about future economic growth and hence corporate profits, but even more on what method you choose for valuing shares. A growing band of analysts who think the market is bottoming out points to a tried old method, called the Fed model. It looks at the gap between the earnings yield (earnings per share divided by the share price) of the S&P 500 and the yield on ten-year Treasury bonds. Buy, the model screams. Compared with bond yields, American shares are at their cheapest since 1987, or since 1980 if forward-looking earnings are used.

Not so fast. The Fed model may have been a good predictor of value during the bull market of the 1980s

and 1990s, but today's environment is suddenly different. Powerful deflationary forces arise when stockmarket and high-technology bubbles burst, and when there are savage cuts in inventories and company investment. If bond yields are falling because a deflationary trend has taken hold, that is no longer good for equities. Just look at Japan since 1990 and the rest of Asia after its financial crisis of 1997-98.

Deflation helps to explain why, for the first time since the 1930s, share prices have not responded to aggressive easing by the Federal Reserve, even though interest rates are at a 40-year low. Bonds and equities, says Christopher Wood of CLSA, a securities house, have decoupled. Bonds, not equities, are the best asset class in times of deflation—notably euro bonds, if the currency continues to rise above the parity it breached against the dollar this week.

What are better measures of share valuation, then? In America, the price/earnings (p/e) ratio—share prices divided by earnings per share—still assumes implausibly high growth in company earnings. The post-war average p/e for the S&P 500 is 15; now it is 40, implying a drop in share prices of three-fifths to return to the historical norm. Yes, but the ratio is high in part because earnings have been hit by all sorts of exceptional costs and write-offs. That is precisely the problem, retorts Martin Wolf in the *Financial Times*. These write-offs reflect earnings that companies exaggerated in the boom years. Who is to say that today's reported figures do not hide more nasty surprises, in the form of manipulated earnings, duff investments or outright fraud?

Investors, in other words, ought logically to demand a higher risk premium for holding equities, implying lower share prices. Dresdner Kleinwort Wasserstein does a back-of-the-envelope estimate. That firm supposes that investors now expect a very modest 7% annual return from American equities (four percentage points more—this is the equity-risk premium—than the return on Treasury bonds indexed against inflation). Such a risk premium implies that the S&P 500 may still need to fall by another 40-50%.

Here's another quaint notion, one that would have been laughed out of hand not long ago: judge shares by the dividend cheques companies write. If investors can no longer count on capital gains from their equity holdings, a steady flow of income, namely dividends, might well prove welcome. Again, the idea bodes ill for current share prices in America. The dividend yield on American shares averages 1.7%, though add in share buybacks, which increase returns to shareholders, and the figure rises to 2.3%. Assume a trend rate of growth for the American economy of, say, 3%. Then, very roughly, the expected long-term return on equities should be the two figures added together—that is, 5.3%. Since the return from index-linked Treasuries is just 3%, this implies a very small premium for the risk of holding equities of just 2.3%. Lower share prices are the conclusion.

There was a time when Europe could afford not to be particularly bothered by what happened in American markets: no longer. Between 1976 and 1999, correlations between American and European markets were low, ranging from 0.24 for Italy (0.0 represents no correlation and 1.0 represents lock-step movement) to 0.5 for Britain. Since late 2000 correlations have been as high as 0.9. Some correlation is justified by growing trade and investment linkages between America and Europe. Some, too, is explained by a similar trajectory in Europe of an asset-driven boom and bust. Still, it is hard to argue that European excesses were greater than America's, and certainly stockmarkets did not rise as high. Yet they have fallen by more.

The outcome is that, by most measures of valuation, share values in Europe are more justifiable than they are in America. In Britain, for instance, the equity-risk premium is reckoned to be at around its historical average. Certainly, p/e ratios there are back to their average; they are below average on the continent. In a look at implied volatility in the options market, Lehman Brothers says that continental share valuations are showing signs of distress akin to the time of the Russian crisis of 1998 and last September's attacks. It bets on a rally before long.

If the new era of tightened correlation allows it. In this bear market, jittery investors seem to have sold indiscriminately in favour of bonds with a cast-iron return. That leads to a final concern. Just as stockmarkets overshot on the way up, so they will overshoot on the way down. No big deal, you might think—a chance, even, for bold investors to make a killing. The danger comes when plunging stockmarkets swamp an emerging economic recovery. That has not happened yet. Yet the risks have risen over these turbulent weeks.

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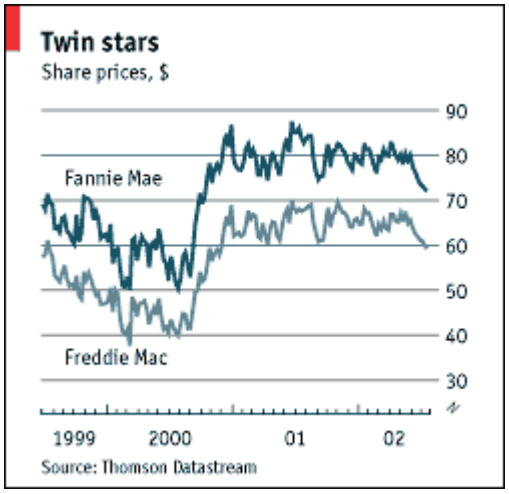
Fannie Mae and Freddie Mac

Mortgage myopia

Jul 18th 2002 | NEW YORK
From The Economist print edition

Scrutiny, at last, of Fannie Mae and Freddie Mac



A TEST for how well Congress can reorder America's financial system is whether it tames its own wayward children. Fannie Mae, Freddie Mac, the Federal Home Loan Bank System and other financial institutions were created by the government years ago to provide liquidity in markets that have long since grown beyond the need for government support.

All of these government-sponsored enterprises operate under special laws that, to varying degrees, provide advantages over their private-sector competitors: lower tax obligations, lighter disclosure requirements, freedom from marking securities they hold to market prices, an implicit (though usually denied) government guarantee for their debt—and, because of all the above, a cost of funding below even the most creditworthy private firms.

Their competitive advantage has allowed these organisations to become huge participants in some of the world's biggest financial markets. In home finance, for instance, they have issued three-fifths of the $4 trillion in outstanding mortgage-backed securities in America. Their annual rate of growth in assets is over 15%, double the overall growth in mortgages. Understandably, many of the big banks and financial institutions are livid over their loss of market share.

In the past, says Bert Ely, whose consultancy follows financial policy, objections were met by heavy lobbying, the appointment of people with political connections to managerial and board posts, and marketing campaigns to suggest that these entities furthered such American values as home ownership and farming. Now, opposition to their favoured status is mounting among the banks and financial institutions that compete for market share, and mounting even in the nation's capital. On July 15th congressional hearings on these enterprises restarted, after a year's hiatus. Three days earlier, Fannie Mae and Freddie Mac agreed to file the same quarterly and annual financial reports required of every other publicly traded company.

It is a start, but only a start. After all, the agreement lets both Fannie Mae and Freddie Mac remain exempt from the Securities Act of 1933, the bedrock legislation for America's public markets that covers disclosure for security offerings. Yet few companies are more active offerers, rebundling mortgages into issues of mortgage-backed bonds.

Their continuing exemption breeds two suspicions on Wall Street, although they are admittedly contradictory. The first is that they retain the better mortgage-backed securities on their books, that is, the ones with less risk of being repaid early; they then flog off the rest. Over time, this would push up mortgage rates and undermine the rationale for Congress creating these agencies in the first place.

Of equal concern in other parts of the market is that Fannie Mae and Freddie Mac are in fact keeping the poorer quality of mortgages on their books, and so concealing possible problems in their fast-growing balance sheets. Together, the two agencies hold well over $1 trillion in mortgage-backed securities. Fannie Mae and Freddie Mac began testing a more sophisticated measure of capital adequacy—running to 600 pages of prescription—only last September, after a ten-year delay. They met their targets for capital adequacy only through the heavy use of derivatives. How vulnerable does that leave them to the collapse of a big derivatives trader?

Any crisis at Fannie Mae and Freddie Mac would have consequences for the financial system. Mutual funds are large holders of their debt. So, too, are banks and thrifts, because the debt of government agencies is exempt from normal rules limiting exposure to any one borrower. In the event of a crisis, it is hard to imagine any institution apart from the Treasury Department with the financial clout to arrange a rescue.

Testifying to Congress this week, a Treasury under-secretary, Peter Fisher, said that the proposed changes to Fannie Mae and Freddie Mac did not go far enough. For instance, they did not cover other similar bodies, including two farm-credit operations and another providing student loans. “The government-sponsored entities—and particularly the housing entities—are no longer modest experiments on the fringes of our financial system,” said Mr Fisher. “They need to be role models for our system of investor protection, not exceptions to it.”

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Robertson Stephens

Boom, fizzle, silence

Jul 18th 2002 | NEW YORK
From The Economist print edition

Pulling the plug on a bank that served the high-tech world

ON JULY 12th FleetBoston, New England's biggest commercial bank, announced the closure of Robertson Stephens, a boutique investment bank in San Francisco that had served Silicon Valley's high-tech companies. The firm was once escorted by high hopes.

Its end was bitter and botched. When FleetBoston said that Robertson Stephens was for sale, not only did specialist technology investment bankers flee; so did top bankers in health care, retailing and consumer goods. Possible bidders found themselves appraising a rapidly shrinking firm. A last-ditch effort to sell the bank to its staff engendered more distrust. In the end, FleetBoston decided on closure, and staff were abruptly told to leave their offices.

Not that they had much work to do. Robertson Stephens took part in only six small offerings of secondary shares this year, and led none. Its last initial public offering was in December, for Nassda, a software company. It was a comedown for a firm that at its peak in 1999 had been lead manager for the offerings of 45 companies—even if many of those, such as Critical Path, Value America and Elastic Networks, swiftly blew up.

The end of Robertson Stephens follows what has become a familiar pattern: years of respectable if modest success, a bout of spectacular returns, acquisition by a larger outfit—and then decline or extinction. The three firms that competed most directly with Robertson Stephens—Alex Brown, Hambrecht & Quist and Montgomery Securities—were acquired by big banks and have since disappeared either in whole or in part.

Robertson emerged from a firm founded in 1969, at the peak of a bull market. It survived the grinding bear markets of the 1970s. But a huge growth in business in the 1990s led to ballooning operations and a succession of owners with ever-changing plans. In 1997 it was sold to Bank of America, also of San Francisco. A year later Bank of America merged with NationsBank, from Charlotte, North Carolina. NationsBank had indigestion from acquiring Montgomery Securities, Robertson's long-standing rival. So Robertson was sold once again, this time to BankBoston, which then merged with Fleet Financial.

With all this deal-making, it is not clear that much thought was ever given to the investment bank's integration and to its running. The firm's founder, Sanford Robertson, described the union with BankBoston as “a great combination”, and promptly left.

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Rural credit in China

Neither creditable nor co-operative

Jul 18th 2002 | BEIJING
From The Economist print edition

China's financial system in trouble in the country as well as in the cities

IF CHINA'S state-owned commercial banks seem perilously burdened by bad debts, consider the even more precarious condition of the country's rural financial sector. In the villages, the only formal banking institutions are what are known as rural credit co-operatives. These enjoy the distinction in China of having been officially declared insolvent.

The rural credit co-operatives are ill-named. They are often reluctant to provide credit and they are not run as co-operatives, for their customers have no say in their operations and do not share any profits. Until 1996 they were offshoots of the big Agricultural Bank of China. Since then, they have been supervised by the central bank, the People's Bank of China, though they are pretty much run by county governments. Even the word “rural” is misleading. Most of their deposits are sucked up and put in the urban banking system. Farmers usually find it easier to borrow from friends or relatives, or from black-market moneylenders.

Yet the co-operatives remain a big part of China's financial system. Last year they accounted for 12% of deposits and 11% of loans. In recent years, commercial banks (including the Agricultural Bank) have closed down branches in the countryside. Yet some 40,000 credit co-operatives remain in place, with one in almost every township, as the larger villages or small rural towns are known.

If, as the government claims, the credit co-operatives are beginning to turn a profit after six years of losses, it is not because they are any better run. In an effort to revitalise a stagnant rural economy, the central bank has pumped more than $9 billion into them hoping that they will lend more to farmers. As a result, the volume of lending to rural households has seen a modest increase—usually short-term lending for buying seed and fertiliser. The co-operatives may make a slight profit from this, but only thanks to the central bank's cheap credit. The root causes of their problems—unclear ownership rights, government interference, bad management and a lack of competition, to name but a few—have yet to be dealt with.

About 30% of the co-operatives' loans are non-performing, and that is a conservative estimate

The co-operatives themselves are not entirely to blame. At the time of their separation, the Agricultural Bank of China kept many of the better borrowers, mostly profitable rural enterprises, on its own books and left the co-operatives with the rest. Three years ago, the government decided to close down another class of financial institution in the countryside, the ill-regulated rural credit foundations. These had sprung up across China in the 1990s, attracting deposits by illegally setting higher interest rates than the co-operatives and banks. But reckless lending to rural enterprises ruined them, prompting the government to step in to prevent a wider financial crisis. The co-operatives inherited the bad-loan portfolios of the credit institutions. Zhang Yuanhong of the Chinese Academy of Social Sciences says that about 30% of the co-operatives' loans are non-performing, and that is a conservative estimate.

Over the past two years, the government has experimented with reforms in the coastal province of Jiangsu. With the help of interest-free loans from the central bank, the co-operatives have been turned into commercial banks complete with shareholders. He Guangwen of China Agricultural University estimates that to do this nationwide would take up to $25 billion in central-bank funds. The government promised a reform plan for the whole country by the end of 2001, but it has yet to materialise.

The difficulty is that what works for Jiangsu, a relatively prosperous province with many rural enterprises, may not necessarily work for poorer provinces that are more heavily dependent on agriculture. The government has complicated the task by requiring the co-operatives to play a leading part in helping

poor farmers get access to credit. Little money is to be made from small loans, with high overhead costs involved in administering them.

The government is anxious to avoid any move that would cause farmers to rush to withdraw their savings. The closure of the credit foundations triggered a panicky spate of withdrawals from co-operatives. Such incidents still occur from time to time. When they do, the central bank comes to the rescue. It helps to prevent a wider meltdown, but does little to encourage commercially sensible lending.

The solution may have to involve a mix of approaches, from commercial banking in the wealthier areas near the eastern seaboard to genuinely co-operative institutions in poorer regions. It will also have to allow remittances between different parts of the country, for which there is at present no facility—the reason why many farmers prefer to deposit their money in rural post offices. “Until you can get a more competitive situation,” says Andrew Watson, the Ford Foundation's representative in Beijing, “with either real co-operatives or various forms of local private banks or whatever, the whole system is going to be difficult to manage.”

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Bank of China

One country, two banks

Jul 18th 2002 | HONG KONG
From The Economist print edition

For the first time at a big state bank, outside capital is invited—up to a point

Reuters

Where patriots lead, punters follow

AS *THE Economist* went to press this week, an initial public offering of shares in the Hong Kong subsidiary of the Bank of China, one of the mainland's four state-owned banks, seemed already to be oversubscribed. The first to express interest was Standard Chartered, a British bank with ambitions in mainland China. Then Hong Kong's property tycoons—all unerring friends of Beijing—piled in, led by Li Ka-shing, the city's richest magnate. Thus reassured, students and housewives began queuing at bank branches for application forms. The only investors still sitting on the fence were global fund managers.

The listing prospectus, published on July 15th, is probably the most honest document ever published by a Chinese state bank. “We believe,” it says, “that we are financially independent.” Only believe? The precise degree of independence matters. In Hong Kong, the Bank of China is, after HSBC, the city's second-largest deposit-taker and lender, one of its three issuers of paper currency, and the owner of its most spectacular skyscraper. Among its peer group, on the other hand, it looks decidedly mediocre. Bad loans came to 11% of total loans last year, almost twice the Hong Kong average.

For some investors, such as Standard Chartered, the big difference is that the bank is the only one in Hong Kong that is owned by a mainland parent. As a member of the World Trade Organisation, China has to open its banking system to foreigners. This will benefit those with access to a mainland distribution network.

For most investors, however, the link represents risk. Under any proper accounting, the parent bank would certainly be insolvent—though less emphatically so than the other three big state banks. The international arm needs to protest its independence in order to persuade world investors that foreign money will not be used to engineer a bail-out of its mainland parent.

Even short of that, the affiliation could cause nightmares. One reason why the share offering was delayed, and its New York tranche scrapped entirely, was a series of revelations earlier this year of fraud within the Bank of China. These ranged from nearly $480m of embezzlements at a southern bank branch on the mainland to irregularities by the bank's former chairman, Wang Xuebing, who now faces prosecution in China. The prospectus warns that “other problems associated with past deficiencies may come to light.”

So how independent should investors believe the subsidiary to be? Only a quarter of the bank's equity is for sale in the public offering—for a bit less than $3 billion. That leaves the parent with most of the voting rights and the power to appoint directors. On the other hand, minority investors will have redress in Hong Kong's courts to sue if they feel ripped off, and the four independent directors will keep that in mind. As for the other directors—above all, Liu Mingkang, the bank's chairman both on the mainland and in Hong Kong—the incentives are also reassuring. Any perceived failure in the debut of China's banking system on world capital markets would mean a loss of face at home, and probably political death. Fund managers, by contrast, have only money to lose.

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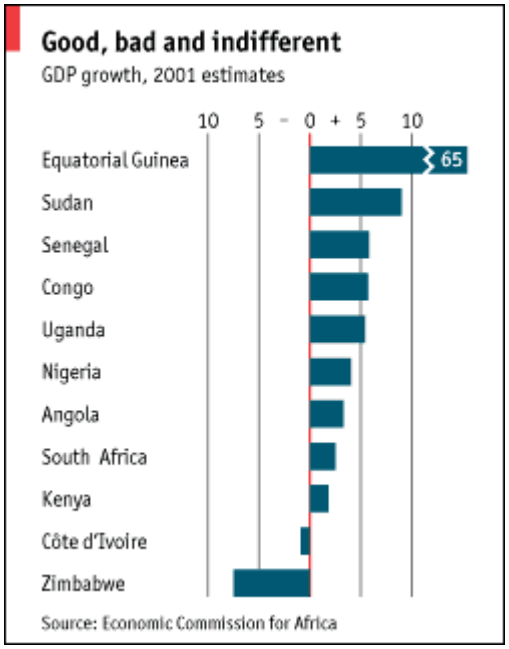
Africa's economies

A look on the brighter side

Jul 18th 2002 | JOHANNESBURG
From The Economist print edition

The UN releases a mildly more hopeful report on Africa

AFRO-OPTIMISTS were in good cheer this week. The World Bank's James Wolfensohn, touring parts of Africa where peace is breaking out, enthused over better economic management after visiting Rwanda and Congo. He wants Congo rewarded with hefty debt relief. On July 16th the United Nations Economic Commission for Africa released an encouraging report on the continent's economies. They are doing better despite the global slowdown, it says. Last year Africa notched up average GDP growth of 4.3%, compared with 3.5% in 2000, says the UN. By contrast, all other developing regions did worse last year than in 2000.



Reliable figures are notoriously hard to find in Africa, and any reckoning of overall performance hides wild extremes. GDP in tiny, oil-rich Equatorial Guinea grew by two-thirds, surely some kind of a record. But in troubled Zimbabwe it shrank fast in 2001, and even faster this year. Yet the overall trend still looks pretty good. Of 53 economies, 37 managed growth of more than 3% in 2001, a sharp increase on the previous year. The UN says that average income per head rose by nearly 2% last year.

Africa's relative success owed a lot to lower oil prices, lower inflation (the median rate is now down to 5%, says the International Monetary Fund), better farming and new exports to America under the Africa Growth and Opportunity Act. More African governments have adopted policies that encourage economic growth and private business, through tax reform, privatisation and reducing deficits. Stopping conflict clearly helped too: both Ethiopia and Eritrea saw their economies boom after ending a costly border war, and even wretched Sierra Leone mustered 5% growth after the end of its civil war. More good news could follow from peace in Angola this year. What is more, the five countries with biggish economies—South Africa, Morocco, Algeria, Tunisia and Egypt, which account for well over half the continent's GDP—managed to attract over $9 billion of foreign investment last year, nearly double the rate in 2000.

Does all this mean Africa will outperform other developing regions this year? Almost certainly not. Even though Africa's growth rate has risen from a small base, it still has not caught up with the rates in parts of Asia, such as India and China. And last year's good showing despite the global gloom reflects how much of Africa remains isolated from the world economy. So it will benefit less than other markets from any upturn. This year Africa is likely to attract a measly 2.3% share of foreign investment worldwide, as the IMF's chief economist, Kenneth Rogoff, recently pointed out. The continent will continue to depend greatly on good rains and harvests. Southern Africa's drought and a food shortage, compounded by the collapse of Zimbabwe, bode ill for 2002. As last year's successes showed, until wars and bad governments are done away with, prosperity is deferred.

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European Central Bank

French farce

Jul 18th 2002 | PARIS
From The Economist print edition

Jean-Claude Trichet faces new obstacles in his quest to head the ECB

Where am I going next year?

WHOEVER said central banking was dull? It seems that a trial may now be on pitting Jean-Claude Trichet, governor of France's central bank, against Philippe Courroye, France's top magistrate. Off, as a result, is Mr Trichet's once-sure appointment to the presidency of the European Central Bank (ECB) next summer. On July 15th Mr Courroye ruled that Mr Trichet and eight others must answer for their roles in the filing in 1991 and 1992 of misleading accounts by Crédit Lyonnais, a then state-controlled and fraud-ridden bank.

If found guilty, Mr Trichet would face a two-year prison sentence and a fine. But even if not guilty, the slow timetable for justice in France makes it hard to maintain his lock on the ECB. A trial cannot start before next March, and it is unlikely to be a short affair. Yet Wim Duisenberg, the ECB's current head, has announced that he will step down in July 2003. Twitchy European governments are likely to insist on a firm successor before Mr Trichet can clear his name.

Mr Trichet's problem triggered much conjecture. Was it bad news for the euro, even though it simultaneously breached parity with the dollar? Might Mr Duisenberg be asked to stay on longer? Would another French candidate be acceptable—for instance Christian Noyer, until recently an ECB vice-president, if he is eligible (which some EU lawyers say he may not be), Jean Lemierre, head of the European Bank for Reconstruction and Development, or Laurent Fabius, a former finance minister?

Such questions raise two more. One is whether it matters who heads the ECB. The bank has done a competent economic job despite the euro's weakness and a series of gaffes that has taught Mr Duisenberg that the best policy is silence or deliberate obscurity. Mr Trichet has great media savvy, but the lack of his presence will scarcely reduce the bank to impotence, let alone incompetence.

But the biggest question is why the next ECB president has to be French. President Jacques Chirac bullied his fellow Europeans in 1998 into agreeing that Mr Duisenberg would step down before his eight-year term was up in favour of a Frenchman. Yet this agreement could surely be reopened in the interests of finding the best candidate.

There is another element of farce. The reason why Mr Trichet is judicially compromised is that Mr Chirac ordered an investigation into Crédit Lyonnais's accounts in 1996; the president was peeved by Mr Trichet's tight monetary policy, and wanted to embarrass him. Only a last-minute stage-effect might now give Mr Chirac a happy French finale. An amnesty, perhaps? Don't rule it out.

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Economics focus

Convergence, period

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From The Economist print edition

Is global inequality really getting worse? A new study says no

MOST people who have a view on the matter—regardless of whether they are critics of globalisation or advocates—accept that global inequality is getting worse. Most official agencies either say or seem to suppose that global inequality is rising. In a new paper* on the subject, Xavier Sala-i-Martin of Columbia University quotes the typical and widely cited United Nations' *Human Development Report*. In 1999 this said:

> In 1960, the 20% of the world's people in the richest countries had 30 times the income of the poorest 20%. In 1997, 74 times as much. This continues the trend of nearly two centuries. Some have predicted convergence, but the past decade has shown increasing concentration of income among people, corporations and countries.

How does the UN know that global inequality has grown much worse? First, its economists say, inequality has worsened within countries. Second, inequality has worsened across countries. From these two things, the UN reckons, it follows, third, that inequality among the people of the world is rising as well.

Mr Sala-i-Martin agrees that inequality has probably increased, on average, within countries. The picture is not clear-cut, however. Inequality has gone up in some countries and down in others. (Rapid globalisation does not push all one way: emerging-market globalisers such as South Korea and Indonesia have seen inequality fall.) On the whole, though, the author reckons that within-country inequality has most likely gone up during recent decades.

What about inequality across countries? On this, the UN neglects an important point. If you measure incomes in terms of purchasing power rather than at market exchange rates, incomes are a lot more equal. (The reason is that the cost of living is lower in poor countries.) When the UN says that the incomes of the richest 20% were 30 times bigger than the incomes of the poorest 20% in 1960, and 74 times bigger in 1997, it is using market exchange rates. In purchasing-power terms, the corresponding ratios were 11 and 15. Despite the fall after 1980 (when the ratio was 16) the trend for the period as a whole is nonetheless up.

Yet another measure (the cross-country variance of income per head) confirms this. Over the past 30 years, rich countries have grown richer and most of the very poorest have stayed very poor. This is the pattern that Harvard's Lant Pritchett referred to in the title of his well-known paper, “Divergence, Big Time”.

But hang on. Given propositions one and two—rising within-country inequality, and rising across-country inequality—it does not follow, as you might suppose, that global inequality itself is rising. Why not?

Mr Sala-i-Martin explains. Imagine that five-sixths of the world's population live in poor and stagnant economies, and one-sixth in rich fast-growing ones. In across-country terms, this gives you “divergence, big time”. Now imagine that one poor but very populous economy starts to grow very quickly. At the same time, inequality within this country worsens somewhat.

Despite its size, this country is only one data-point in the across-country comparisons: its rapid growth is not enough to make any difference to divergence. So you have rising within-country inequality and rising across-country inequality. Yet one-sixth of the world's population, by assumption, is seeing its incomes rise rapidly towards those of the rich. Inequality measured across all the people of the world, therefore, may very well be falling.

A far-fetched case? No, Mr Sala-i-Martin points out, this is exactly what has been happening. The big poor country growing very fast is China. (India has also been doing pretty well.) If you simply weight the across-country measures of divergence by population, you see not a rising trend of inequality, but the opposite: as the author puts it, not “divergence, big time” but “convergence, period”.

Country variance weighted by population may be better than the unweighted sort, but still it ignores inequality within countries. Mr Sala-i-Martin therefore sets about combining both kinds of information, to see how income is distributed across the world's people. He finds that rising global inequality is “nowhere to be seen”. This is true on seven different measures: “the Gini coefficient, the variance of log income, two Atkinson's indexes, and three generalised entropy indexes”. So there.

For those more interested in relieving poverty than in narrowing the gaps between rich and poor, the results from the estimated distribution are equally pleasing: the proportion of people living on less than a dollar a day fell from 20% in 1970 to 5% in 1998; the proportion living on less than two dollars a day fell from 44% to 8%. The headcount of poverty worldwide has fallen by some 400m.

The headcount of poverty worldwide has fallen by some 400m

The only bad news is that, after the respite provided recently by surging globalisation, inequality may well resume its long-term historical trend and start rising again in due course. The reason is that China and India will no longer be poor—and if the world's poorest countries, mainly in Africa, continue to stagnate, the global dispersion of incomes will widen. Whether the main problem here is African poverty or global inequality (caused by China and India leaving poverty behind) is one for the UN's economists to think about.

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*"Mr Sala-i-Martin's study is "The Disturbing 'Rise' of Global Income Inequality", NBER Working Paper No 8904. It is available on the NBER website. A version also appears on Mr Sala-i-Martin's own website.

"Divergence, Big Time" by Lant Pritchett was in the Journal of Economic Perspectives, Summer 1997, Vol 11, No 3. An earlier version appeared as World Bank Research Working Paper No 1522.

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Nuclear fusion

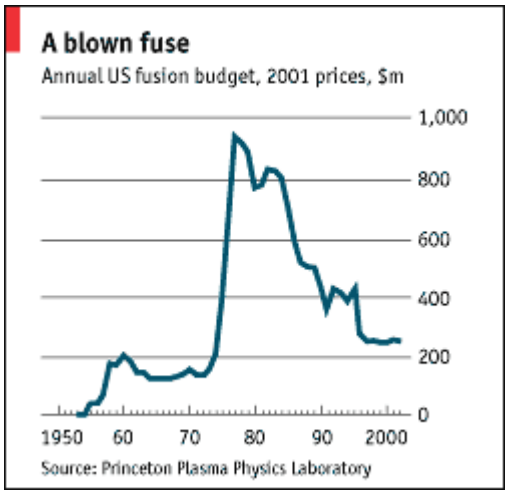
It's impossible. And what's more, it's improbable

Jul 18th 2002
From The Economist print edition

This month offers a chance for America's fusion researchers to stay in the game

Get article background

SOME say that a dollar spent on nuclear fusion is a dollar wasted. And many, many dollars have been spent on it, as physicists try to duplicate, in a controlled setting, the process by which the sun shines. Since 1951, America alone has devoted more than $17 billion (see chart) to working out how to fuse atomic nuclei so as to generate an inexhaustible supply of clean, safe power.



The claim that this money is wholly wasted may not be entirely fair, though. Fusion science has made a big return on this investment in the form of a new universal constant. This constant is the number 30, a figure that has for the past half-century or so been cited almost religiously by researchers as the number of years that it will take before fusion power becomes a commercial reality.

That this number has not fallen explains why the budget for fusion research in America has. Fit a line to the decline, reckons Pete Politzer, a scientist at General Atomics, an atomic-energy company based in San Diego, and it looks as though fusion funding will disappear entirely by 2007. So it is with a heightened sense of purpose that America's fusion physicists have gathered for a fortnight's conference in Snowmass, Colorado, to discuss the future of their country's fusion-research programme. If they act quickly and in concert with their colleagues around the world, they might save their jobs and their research budgets from a quiet and unlamented death.

Star-struck

The physicists gathered at Snowmass must decide whether to recommend that their government rejoins a team from Europe, Japan, Russia and Canada, which is planning to build a device known as the

International Thermonuclear Experimental Reactor (ITER). This will try to create a “burning” (ie, fusing) plasma of hot, ionised hydrogen gas. Japan, Canada, Spain and France have all offered to host this facility, and they are keen to get the United States to join in and help meet the $5 billion price tag. To rejoin the collaboration could cost America between $500m and $1 billion, according to Ned Sauthoff, a physicist at Princeton University who is one of the chairmen of the conference.

The prospect of America stumping up such a sum is not as remote as it might at first appear. The United States withdrew from ITER in 1999, citing budgetary constraints. But since then, the remaining members have halved the project's budget. Meanwhile, the Bush administration has slightly increased its proposed funding for fusion research, and has shown support for experiments at American plasma-physics laboratories. And, at a meeting of G8 energy ministers in Detroit this May, Spencer Abraham, America's energy secretary, said that President Bush was keen on fusion and perhaps on rejoining ITER as well.

Fusion physicists say that, because of its scale and potential output, ITER could be the last experiment needed before construction of a working fusion power-plant can begin. (No prizes for guessing how many years off that will be.) The proposed device would use superconducting magnets to confine a burning plasma of deuterium and tritium, two isotopes of hydrogen, in a doughnut-shaped reactor known as a “tokamak”. The interior of the plasma would have to be maintained at around 100m°C for the deuterium and tritium to fuse, and energy to be produced.

If all goes as planned, ITER will generate about 400 megawatts of thermal power, from an energy input about one-tenth of that. Depending on how you do the sums, ITER might thus be the first fusion reactor to produce significantly more energy than is put in to heat up the plasma. For safety reasons, however, the excess thermal energy produced will be released through cooling towers rather than harnessed and converted into electricity.

Proposals for smaller tokamaks are also being considered. One is the Fusion Ignition Research Experiment (FIRE), which has been designed by an American team. Its planners estimate that the burning plasma in FIRE would produce between five and 20 times as much energy as is required to heat it up. The experiment would cost about $1 billion that in all likelihood the Americans would have to find by themselves, and it would take about seven years to build, whereas ITER would take 12.

The goal of FIRE would be to perform experiments on magnetically controlled burning plasmas. Its opponents say that its smaller size means that FIRE could not give physicists enough information to guarantee that engineers would be able to build a fusion power-plant. At Snowmass, the physicists must sort out these claims, and decide whether it is worth asking for funding for FIRE as well as for ITER, instead of ITER, or not at all.

A third proposal under discussion at Snowmass is called IGNITOR. This was designed some years ago by a team led by Bruno Coppi, a physicist at the Massachusetts Institute of Technology. The project would be a collaboration with Italian scientists and is the smallest and cheapest of the tokamak proposals. As with FIRE, however, there are doubts about whether building IGNITOR will advance the technology of fusion power enough. The final option that will be considered at Snowmass, to do nothing at all, is the cheapest and most modest alternative, but also the one least likely to be advanced.

Economic downturn

On July 19th, the organisers of the Snowmass meeting are presenting a report on which option the attendees want America to support. Rallying physicists behind any choice will be a hard task. Rallying political support will be harder still.

Some have suggested that fusion enthusiasts should lobby for these projects on the grounds that they advance the understanding of the “pure science” of burning plasma. Particle physicists, they argue, get away with spending vast sums of public money studying the pure science of fundamental particles. But this line of argument is doomed. The only reason to understand burning plasmas is in order to build a commercial fusion power-plant. In contrast, understanding the physics of subatomic particles is interesting for the light it sheds on the fundamental nature of the universe.

To push for a project, only to have its funding denied or cancelled again, would send yet another discouraging signal to a group of scientists who sorely need a new injection of talent and money if they are to continue. On the other hand, that might be exactly the right signal to send. Thirty years is a long time for an ambitious young physicist to achieve nothing at all.

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Cancer treatment

Radioing for help

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From The Economist print edition

Gene therapy may make radiotherapy more effective

A CANCER diagnosis may not always be a death sentence, but cancers of various sorts still kill more than 6m people a year, and few can be cured reliably. The odds might, however, be improved if a model put forward at this week's meeting of the American Association of Physicists in Medicine, held in Montreal, Canada, proves itself in clinical trials.

Paul Keall, a medical physicist at Virginia Commonwealth University (VCU), in Richmond, has calculated that the cure rate could be improved by at least 15% using a novel combination of gene therapy and radiotherapy. X-rays have been killing cancers for donkeys' years. Increasingly sophisticated radiotherapy techniques have made the treatment more effective. But it is through the use of gene therapy to make cancer cells more susceptible to radiation that there lies an even better hope of a cure, according to Dr Keall.

Radiation kills cells because it damages their DNA, creating errors in the genetic code and even breaking the double-helix. The accumulation of these faults eventually causes the cell, or its daughters who inherit the damage, to die. Both the rate and the way that a cell divides help to determine how fast radiation destroys its family line. So cancer cells, which multiply rapidly in an abnormal manner, are more affected than slowly growing healthy cells.

However, healthy cells—particularly those in tissues such as skin and hair-follicles that replicate a lot—are damaged to a certain extent by the radiation. The death of these cells causes nasty side-effects in the patient. Radiotherapists try to minimise such harm by aiming their X-rays carefully, but the best way to reduce side-effects is to lower the radiation dose. And this is where the gene therapy comes in.

Some of Dr Keall's colleagues at VCU have shown in laboratory experiments that they can “radiosensitise” cancer cells by blocking the function of a protein called epidermal growth factor (EGF). This substance encourages cells to repair themselves. When a cell is exposed to radiation, the number of EGF receptors in it soars in a protective response.

The researchers found that they could disable this mechanism by causing cells to produce dysfunctional receptors. These bind to EGF and so prevent it reaching receptors that work. To achieve this, a version of the EGF–receptor gene that produces a dysfunctional receptor is inserted into “Trojan” viruses, and those viruses are then injected into the cancerous tissue. When a virus releases its DNA in order to infect a cell, it also releases the inserted DNA. The cell then uses this to manufacture dysfunctional receptor-molecules that in turn mop up EGF.

Laboratory trials in animals have found that cells altered in this fashion are almost twice as sensitive to radiation as are unmodified cells. This is more than enough to make a difference, according to Dr Keall's calculations. The other variable in his model is the fraction of cells in the tumour that are infected by the Trojan virus. The best improvement in tumour control is, not surprisingly, seen when all the cancerous cells are genetically modified. The actual efficiency of infection is hovering around 80%, but that should still be sufficient to weaken a tumour's response to radiation enough to kill it in some cases.

It will be difficult to increase the level of infection unless the virus can be made to attack cancer cells specifically. For now, the researchers rely on skill with the hypodermic needle and a little bit of luck, injecting the virus into the centre of the tumour and hoping that it will distribute evenly throughout the cancer without spreading to the tissues outside. This requires the tumour to be accessible—as, for example head, neck and breast cancers are.

The first human trials of the combined treatment should start within a year. Only when they are completed will Dr Keall know whether the predictions of the model are accurate. Has it raised false hopes or will genetic radiotherapy save real lives?

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African honeybees

Attack of the clones

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South Africa's farming industry is threatened by a genetic curiosity

WHILE humanity agonises over the potential hazards of cloning, another species is facing its own bizarre clone wars. In South Africa, the African honeybee is being devastated by invasions of self-replicating clones—all descendants of a single, long-deceased individual—from another honeybee subspecies. This odd case of social parasitism, ironically brought about by human intervention, is proving both a bane to South African agriculture and a fascinating case for biologists to ponder.

Societies of bees, ants and wasps, in which a fertile queen is attended by a multi-generational brood of barren workers, have to be vigilant against cheating by members who might manage to reproduce individually. Biologists have charted various mechanisms by which such safeguards evolve and are enforced. But sometimes, as in the present case, the system fails spectacularly.

In 1990 South African beekeepers imported Cape honeybees, a different subspecies, from their native habitat in the south of the country to work alongside hives of African honeybees in the north. The chaos this mingling unleashed, as a cloned version of the Cape bees started invading the African-honeybee hives, has been analysed, in a recent edition of *Apidologie*, by Stephen Martin of the University of Sheffield, in England.

According to Dr Martin, the problems stemmed from a coincidence of two oddities. First, worker-laid eggs that occur in other subspecies hatch into males. This is because they contain only one complement of chromosomes, which is the signal in bees, ants and wasps that an embryo should develop into a male. In Cape bees, however, workers' eggs contain two complements of chromosomes, and thus turn into females. These females are, moreover, exact genetic copies of their mother—in other words, clones.

The second oddity is that in 1990, or thereabouts, a single Cape bee hatched with a handful of mutations that made her eggs smell like those of African-honeybee queens. As a result, those eggs were not eaten, as “unauthorised” eggs normally are, by other workers in the hive.

This original Cape bee then wandered into an African-honeybee hive and began working there. This happens frequently on bee farms, where hives are kept in unnatural proximity and abundance, and are frequently transported together in trucks. Unaffected by the African-queen-bee's scent, which normally maintains her majesty's monopoly on reproduction, the interloper activated her ovaries. She laid eggs which hatched into clones of herself. Her daughters did the same, and their descendants swept the hive in a few generations.

Due to behavioural differences between the Cape and African subspecies, the African queen would have died by the 50th day and the hive crashed by the 100th. The clones then dispersed to the winds. Some made their way into new hives, and the pattern has been repeating itself ever since. There are now billions of clones participating in the destruction of South Africa's apiaries. That, obviously, threatens the country's honey industry. But bees do more than make honey. They pollinate plants, including many crops. According to Dr Martin, the effects of pollination brought about by domesticated bees are worth about 20 billion rand ($2 billion) a year. Much of that is at risk.

Something similar seems to have happened in the region twice before, in 1928 and 1977. But those episodes were relatively mild compared with the present one. This may be due in part to changes in beekeeping practices between then and now. The *clone du jour* may also be more virulent than her forerunners. Yet, despite their seeming success in the Darwinian game of outbreeding the competition, the Cape bee clones are apparently incapable of establishing self-sustaining hives of their own. The rapid and total destruction the clones inflict on their hosts suggests that the phenomenon should peter out as

African-honeybee hives become scarcer. At least, beekeepers hope so.

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The first use of chocolate

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From The Economist print edition

This pot is the earliest known vessel in which chocolate was prepared for consumption. It dates from 600BC, a millennium before the previous record-holder. It was collected from Colha, in Belize, and its contents were analysed by a team led by Jeffrey Hurst, a chemist who works for Hershey Foods, an American confectioner, and Terry Powis, an anthropologist at the University of Texas, Austin. The results, published in *Nature*, show the presence of a chocolate-specific molecule called theobromine. In the 17th-century, at the time of the Spanish conquest, chocolate was prepared by the local Maya by pouring it from pot to pot to foam it up. The spouted shape of the Colha pot suggests this was an ancient practice.

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Correction

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In "Pebble dashed?" (June 29th), we described the Chernobyl nuclear reactor that exploded in 1986 as a pressurised-water reactor. Although it was water-cooled, it was actually graphite-moderated. Reactors of the Chernobyl type are known as RBMKs. Sorry for the mistake.

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Writing about sex

Words fail me

Jul 18th 2002
From The Economist print edition

Corbis

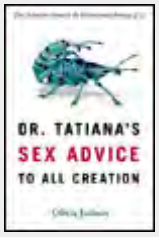
Wild or comic, coupling in animals is quite frighteningly varied, and makes human sex look tame. Is that why most sex writing is so dull?

SEX; what is it good for? Is it, for instance, good for being written about? No other subject has people reaching for their dictionaries in quite the same way. There is pornography, there is eroticism, but is there anything else? D.H. Lawrence did it, Jilly Cooper does it, and everyone literary from Julian Barnes to Anne Michaels to Chloe Hooper does it; but have they actually written about it, or have they written about the stuff that surrounds it, the emotions, the personal politics, the sensuality, the awkwardness? Have they, in point of fact, in the main avoided the act itself?

A clue to writers' coyness might be contained in Olivia Judson's funny and blissfully original new book, which purports to be sex advice offered to the animal kingdom by a universal agony aunt called Dr Tatiana, and amply demonstrates the sheer unyielding ruthlessness of the business of procreation. Dr Tatiana has all the bossy heartiness of Bertie Wooster's Aunt Dahlia, but her science is first-rate. She responds with gusto to pleading letters from the Dandy on the Cowpat, a yellow dung-fly who wants to make his sperm more attractive, or Anxious in Amboseli, an African elephant who is diagnosed as possessing SINBAD (Single Income, No Babe, Absolutely Desperate). I-Like-'Em-Headless-in-Lisbon is a praying mantis who asks Dr Tatiana if she also enjoys the thrilling mid-sex spasms of a partner who has just been decapitated; and we are introduced to a female midge who plunges her proboscis into her mates' heads and turns their innards to a soup “which she slurps up, drinking until she's sucked him dry...only his manhood, which breaks off inside her, betrays the fact that this was no ordinary meal.” There are several kinds of spiders, we learn further, “where there can be no doubting the females' intention to take head, not give it.”

By contrast, Catherine Millet's explicit journal of unending sexual availability seems benign in the extreme. The book has been a bestseller in France and Germany, has received predictably prudish derision from British reviewers but is nevertheless prominent in the bookshops. Ms Millet herself is the editor of a French art journal, *Art Press*; apart from that, she has been enjoying orgies,

Dr Tatiana's Sex Advice to All Creation: The Definitive Guide to the Evolutionary Biology of Sex
By Olivia Judson



Metropolitan Books; 224 pages; $24.
Chatto & Windus; £15.99

Buy it at
Amazon.com
Amazon.co.uk

The Sexual Life of Catherine M
By Catherine Millet

open-air sex and indeed most conceivable kinds of sex for many years, and she has now kindly consented to tell us about it.

Her descriptions are laced with a laconic frankness which veers between intelligent reflection and willed self-objectification; the effect, if not the intention, is certainly pornographic. Her cool appraisals of looking for sex in the Bois de Boulogne are the essence of male sexual fantasy: she gives generously, and asks for nothing, a paradigm utterly foreign to the natural world described by Ms Judson. Ms Millet's book revels in its own sexual laisser-faire; like Tracy Emin's bed, it turns self-revelation into artistic statement. It is theatrical, but in the event limited to being a brilliant flourish. There are very few emotions other than frustration in the book, together with a weary avowal that she wishes it wasn't always her who was the first to get going at orgies.

Thank heaven, then, for Howard Jacobson; often criticised by the politically correct, he is able to milk the pain and humour of human sexual relations in a way that is part Tom Lehrer, part Woody Allen, part Thomas Hardy. He is underrated at home; in France he might be as celebrated as Michel Houellebecq, his writing recognised as of a stature to compare with Philip Roth's: dense, crafted and mature.

There are few writers who match sophistication and provocation in such a way: his latest novel, “Who's Sorry Now?”, describes how Marvin Kreitman, the feisty but sordid luggage baron of south London, swaps partners with his friend Charlie, who is into nice sex and bored with it. Unlike Ms Judson's world of manic, ruthless and deadly copulation, or Ms Millet's one of vacuous self-abasement, Mr Jacobson's mockery of the way in which men are enslaved to their predilections is very funny, very painful and very human. In the end, the simplicity of the sexual clinch is a long way from the richness and absurdity of human desire. And not so interesting to write about.

MICHAEL FISHWICK

Dr Tatiana's Sex Advice to All Creation: The Definitive Guide to the Evolutionary Biology of Sex.
By Olivia Judson.
Metropolitan Books; 224 pages; $24.
Chatto & Windus; £15.99

The Sexual Life of Catherine M.
By Catherine Millet.
Grove Press; 224 pages; $23.
Serpent's Tail; £12

Who's Sorry Now?
By Howard Jacobson.
Jonathan Cape; 336 pages; £16.99

Grove Press; 224 pages; $23.
Serpent's Tail; £12

Buy it at
Amazon.com
Amazon.co.uk

Who's Sorry Now?
By Howard Jacobson

Jonathan Cape; 336 pages; £16.99

Buy it at
Amazon.com
Amazon.co.uk

Olivia Judson formerly worked on the science pages of this newspaper, and her book grew out of a piece for our Christmas issue. Our policy is to identify reviewers of books by or about anyone closely linked to *The Economist*

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About sponsorship

Psychiatry and drugs

The other drug problem

Jul 18th 2002
From The Economist print edition

PSYCHIATRY, like most medicine, is slave to fashion. Definitions of mental illness and forms of treatment have shifted with broader changes in science and society. Some professionals use to think of schizophrenia, for example, as due to family dysfunction and treatable by psychotherapy; now it tends to be seen as a physical disorder to be managed by drugs.

“The Creation of Psychopharmacology” sets out to chart these shifts of this kind, with an emphasis on the origins of the magic-bullet pharmaceuticals of present-day psychiatry. Chlorpromazine, for example, was born in the 1950s out of a search for antihistamines and ended up as the mainstay of treatment for psychosis through an extraordinary sequence of clinical trial-and-error.

The Creation of Psychopharmacology
By David Healy

Harvard University Press; 469 pages; $39.95 and £27.50

Buy it at
Amazon.com
Amazon.co.uk

This crazy-quilt pattern is entirely general, David Healy believes. There is nothing rational or predictable about drug design in his view except the relentless drive of pharmaceutical companies to expand their market share. As a result, money dictates the course of modern psychiatry, and drugs triumph over therapies which lack corporate support. This view is not universally popular, and Dr Healy is used to controversy. When the University of Toronto revoked the offer of a clinical appointment in 2000 after a public lecture by him laying into drug companies, he sued (the two sides recently settled).

Dr Healy's book is full of peculiar characters, such as Henri Baruk who would stride about with a catatonic pigeon on his head, or John Henry Gaddum who used to trip out on LSD for the sake of science. And these are just the doctors. As for the patients, the book movingly describes those rescued with drugs from mute immobility or raving psychosis only to be horribly shaken by side-effects.

These are flashes of human interest in what is otherwise a numbingly thorough survey of the history of psychiatry, from the days of the asylum to our era of cosmetic pharmacology, when drugs are given out for distressing or distracting conduct such as hyperactivity (ie, fidgeting), rather than for genuine disease.

Although he deplores psychobabble—the loose talk and little knowledge which often mars popular debate about mental illness—Dr Healy himself is guilty of psychoramble. His laudable attempts to set psychiatry in a broader social context, bringing in everything from enlightenment philosophy to the Vietnam war, are let down by a weak narrative which fails to link these parts together. Repeating anecdotes, as Dr Healy does with the story of Rousseau's bout of indecent exposure, does not make them any more relevant.

Be warned, though. Dr Healy's primary aim here is to persuade the expert, not the general reader. He tosses out the names of practitioners and disorders with little explanation, and only if you can already tell Bleuler from Kraepelin or hebephrenia from tardive dyskinesia, are you likely to struggle through this detailed and meticulous work. This is a pity. Hidden in a cloud of jargon and technical detail are arresting thoughts about modern medicine and the future of mental health.

The Creation of Psychopharmacology.
By David Healy.
Harvard University Press; 469 pages; $39.95 and £27.50

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About sponsorship

America's popular songs

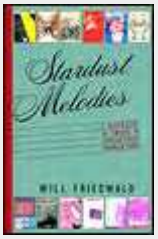
What you can say in a love song

Jul 18th 2002
From The Economist print edition

MANY readers would agree when Will Friedwald includes “Summertime” and “My Funny Valentine” in his top 12, but they might question why “Lush Life” and “Mack The Knife” (a 16-bar strain repeated seven times) are in at the expense, say, of “Smoke Gets In Your Eyes” or “Every Time You Say Goodbye”. It is the love songs which adhere so permanently in the collective subconscious.

Some of the songs in the list owe their celebrity to a famous performance. Where would “Stormy Weather” have been without Ethel Waters? Sometimes a single note can ensure fame and fortune. When Paul Robeson gave the full treatment to “Ol' Man River” it was sliding down to a low F on “Get a little drunk and you land in jay-*erl*” that enriched the lives of all who heard it. Frank Sinatra chose the same song to celebrate his particular virtuosity tumbling from D on “jail”—the last note of the bridge—to G for “Ah”—the first word of the final chorus—on a single breath. Even more extraordinary is the tale that Ethel Merman, starring in “Girl Crazy”, held a high C for 32 bars while the theatre orchestra played the entire chorus of “I Got Rhythm” under her note; modestly she was to claim a mere 16 bars, but you try it! According to Cole Porter, Merman could also flatten or sharpen a note merely for effect, another trick not to be tried in front of the children.

Stardust Melodies: A Biography of Twelve of America's Most Popular Songs
By Will Friedwald



Pantheon Books; 432 pages; $27.50

Buy it at Amazon.com

“As Time Goes By” is a classic because “Casablanca”, the film in which it featured, is a classic, but Arthur “Dooley” Wilson, in the role of Sam who plays it again, could not even play the piano and was dubbed. The song itself would probably have been replaced and a re-shoot was planned, but in the event Ingrid Bergman had already had her hair cropped for her next movie, “For Whom the Bell Tolls”, and so “As Time Goes By” survived.

Mr Friedwald is as obsessive as a train-spotter in his search for examples of the best and worst tracks of his 12 songs, and to tell us their complete biographies. He counted more than 100 Chet Baker versions of “My Funny Valentine” before recommending the Lee Wiley version (“When she sings you can really hear the hurt”). Wiley was a fine singer who deserves to be singled out as are Johnny Hartman and Mark Murphy, singers who also earn honourable mention more than once. As his outstanding example of “Summertime”, Mr Friedwald opts for the Miles Davis-Gil Evans version—a non-vocal choice everyone who has heard it will agree with.

Will songs such as these continue to be composed? No longer are musicals dependent on the plugging of their hits; the sentimentality and decency of a pretty tune and a well-turned lyric are out of vogue. Singers there are in plenty to sing them but where are the songs? Bands dominate. Mr Friedwald does well to remind us of just what we are missing.

Intriguing as his agenda may be and perceptive and scenic the route by which he gets us there, Mr Friedwald lets us down with not one, but three bumps. There is no index, no discography and no complete lyric or score of any of the songs. Whether this is for copyright reasons, or just plain mean, we are frustratingly denied the pleasure of sitting at the piano and exploring the felicities of the chosen dozen which also include “Star Dust”, “The St Louis Blues”, and “Night and Day”.

And felicitous they are, although we often take them for granted, as did those who wrote them. Questioned on words and music as to what came first, one member of a famous songwriting duo shot back, “The telephone call.” And When Johnny Green was asked, *à propos* “Body And Soul”, did he realise that his was to be the most recorded torch song of all time, he replied: “No. All I knew was that it had to

be finished by Wednesday."

Stardust Melodies: A Biography of Twelve of America's Most Popular Songs.
By Will Friedwald.
Pantheon Books; 432 pages; $27.50

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About sponsorship

Ex-Yugoslavia

For the prosecution

Jul 18th 2002
From The Economist print edition

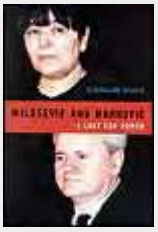
Four books which remind us why justice still needs to be done

SLOBODAN MILOSEVIC, the Serbian ex-leader, is conducting an obstinate defence at his trial in The Hague for war crimes. Since he claims not to accept the court's authority, he refuses to read the documents it gives him. Instead, he cites-selectively-from books on the Yugoslav conflict. What, you wonder, will he make of this double biography by Slavoljub Djukic of himself and his wife, Mira Markovic?

Though published in English as a single volume, it is a condensation of three previous books by Mr Djukic about the ex-Yugoslav leader published in Serbian. It is breezily written and spiced with anecdotes. Mr Milosevic, we learn, held Bosnian Serb leaders in low regard, once telling Radovan Karadzjic, their boss, to "go and lick a salt block".

But Mr Djukic adds little of substance about the war and its causes. He is a fair example of a Milosevic opponent who is nevertheless a Serb nationalist. Like Mr Milosevic, he holds that Yugoslavia's collapse served interests in the West, and he does not mention the massacre at Srebrenica, in which Bosnian Serbs massacred over 7,000 Muslim men and boys.

Milosevic and Markovic: A Lust for Power
By Slavoljub Djukic

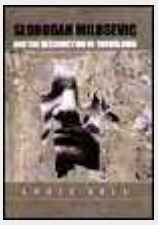


McGill-Queen's University Press; 224 pages; $37.95

Buy it at
Amazon.com
Amazon.co.uk

LOUIS SELL'S study is a far more substantial book, though hardly light reading. Mr Sell spent eight years in Yugoslavia as an American foreign-service officer and attended the Dayton peace conference which brought the Bosnian war formally to an end. His is the most comprehensive and up-to-date account of the war so far published in English. He is fair-minded and keeps his diplomatic cool until the end, when with justice he calls Mr Milosevic "an ugly killer" who even now denies the fact of horrendous crimes, and his own responsibility for them.

Slobodan Milosevic and the Destruction of Yugoslavia
By Louis Sell



Duke University Press; 432 pages; $34.95 and £25

Buy it at
Amazon.com
Amazon.co.uk

TAKIS MICHAS, a courageous Greek journalist, has written a superb and devastating critique of his country's support of the Serb nationalists in their war for Greater Serbia. He describes Greece's shameless sanctions-busting and the lies of its newspapers. These prevented Greek people from knowing the grim facts and lauded Greek volunteers who took part in the capture of Srebrenica as heroes. The shrillness of anti-Muslim, anti-Albanian and anti-western attitudes, which Mr Michas believes are widespread in his country, is both shocking and sad. He quotes Mikis Theodorakis, a composer, as saying: "I hate Americans and everything American. I hope that the youth will begin to hate everything American."

Unholy Alliance: Greece and Milosevic's Serbia
By Takis Michas

Texas A&M University Press; 200 pages; $29.95 and £24.95

Buy it at
Amazon.com
Amazon.co.uk

IF YOU want to step back and take a more historical view, Stevan Pavlowitch's account of Serbian history from the Middle Ages until today is a good place to start. The author is a Belgrade-born academic who has lived mostly in the West. With so much ground to cover, he travels at a cracking pace, and his account of the wars since 1991 is inevitably compressed. In compensation, he helps us understand the conflict in its historical context. Few will disagree with his closing remark that Serbia after Mr Milosevic is like Jonah released from the belly of the whale, “free to face its problems in stark daylight”.

Serbia: The History of an Idea
By Stevan K. Pavlowitch

New York University Press, 240 pages; $29.95. Hurst; £14.95

Buy it at
Amazon.com
Amazon.co.uk

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About sponsorship

Contemporary opera

A sparkling trio

Jul 18th 2002
From The Economist print edition

A new opera competition has produced a shortlist of striking works from more than 200 hopeful applicants

COMPOSING is slow, thirsty work. Unlike writers, musicians often don't get paid an advance to live on while composing their operas and symphonies. So when a new British philanthropic organisation, the Genesis Foundation, posted a web advertisement at the end of 2000 announcing a competition for new chamber opera, it's no surprise that more than 200 applications arrived, some from as far afield as Ukraine and Argentina.

The force behind the Genesis Foundation is John Studzinski, the American deputy chairman of Morgan Stanley International and a banker who relishes getting things done. An energetic supporter of Tate Modern and the Royal Court theatre in London, Mr Studzinski is a particular fan of new opera. “I'm always surprised there isn't more of it about,” he says. A Roman Catholic, he commissioned Roxana Panufnik to write “Westminster Mass” in celebration of the late Cardinal Basil Hume's 75th birthday. But his commitment to the Genesis prize is his biggest so far. Its aim, he says, is to encourage young artists who might otherwise turn away from writing music and to identify “fresh young talent in the area of composers and librettists and produce a new version of modern chamber opera that could have a broader audience around the world.”

With the project at the halfway mark, the 200 were whittled down to a shortlist of nine composers and librettists, who were given a little money to develop their proposals and who met recently in London to present what they had done so far. The requirement was that each libretto had to be complete and enough music written to stage a 20-minute extract for as many as eight voices and a small chamber orchestra. The mini-performances, at the renowned Almeida theatre in London, were more polished than an ordinary rehearsal yet allowed the audience a rare insight into the process of how a work of music drama is actually created.

Given the catchment, the pieces ranged widely in theme and content. Among them was “Sunset with Pink Pastoral”, a road movie of an opera by an American husband-and-wife team, Christian Asplund and Lara Candland; “Cherry Station”, a Japanese ecodrama with powerful music by Fumio Tamura that analysed the tensions within a small community when its local council decides to cut down two old cherry trees; and “Non Guardate al Domani”, a political oratorio by Filippo del Corno and Angelo Miotto, a journalist, that explored the conflicting passions aroused by the kidnap-murder of an Italian political leader, Aldo Moro, in 1978.

The works were as varied musically as they were in narrative detail. Some were too ambitious; in others the music fought off an overpowering libretto or vice versa. One or two were too complicated to imagine staged. But what distinguished the three winning works was a brazen sense of confidence that their story could be told in no other way than through opera.

Laughter, suicide and survival

“Sirius on Earth” presented a dystopian, satirical vision of the future that could be taken as a heavy and derivative remake of George Orwell's “Nineteen Eighty-Four” were it not for the talent of the work's Canadian composer, Paul Frehner, and his librettist (and sister-in-law), Angela Murphy. On paper, the piece seemed to rely too heavily on the words. But Mr Frehner, whom one of the judges described as “the most naturally gifted and fluent composer of the lot”, was well suited to Ms Murphy's quick wit. Together they succeeded in carrying off one of the hardest of theatrical forms, a fast-paced operatic comedy where the humour is all on stage and not just in the libretto. Proof that they had succeeded was

there in the performers' visible enjoyment of the piece.

A raucous Australian work, “The Eternity Man”, tells the story of a reformed alcoholic and religious ratbag who spent much of the 1950s wandering the streets of Sydney writing the word “Eternity” on walls and bridges in a perfect copperplate hand as if it were a poem. Dorothy Porter, the librettist, and Jonathan Mills have bent the story of the Eternity man to create a vagabond opera that is not a million miles from “Peter Grimes”. That the hero was illiterate and that this was the only word he knew how to write serves only to prove how much his is a spiritual quest. Literally dragging himself out of the dirt, he throws himself off the Gap, a Sydney suicide spot, into the Pacific Ocean, his search for eternity over.

The most arresting piece was “Thwaite” a Rabelaisian musical drama by an aspiring young playwright, Simon Doyle, and Jürgen Simpson, a prominent member of Dublin's underground music scene. Set in a bleak post-Holocaust landscape, the characters seem to arrive from nowhere and announce themselves, their needs and desires. Despite the darkness, the libretto is witty and joyful and never overpowers the collaboration between the two artists. Inspired by Mr Doyle's fluidity of tongue, Mr Simpson has clearly understood that the characters are a gift for song. There is an overall logic to the piece—to the interaction of libretto, music and characters—that leaps out to the audience, demonstrating that although you may never have been there, the world that the two have created is completely persuasive.

Something special

The Genesis award is rare as prizes in the performing arts go, for it promises both payment while the works are being written and an undertaking to have them staged once they are completed. When it succeeds as an artistic form, opera is itself special, being neither a musical, nor a play set to music, but a dramatic idea in which notes and words seem to grow out of each other. All three of the new operas commissioned will be put on, again at the Almeida, in July 2003. The stagings should be well worth waiting for.

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About sponsorship

Yousuf Karsh

Jul 18th 2002
From The Economist print edition

Yousuf Karsh, photographer of the famous, died on July 13th, aged 93

AP

SO MUCH praise has been heaped upon Yousuf Karsh that it is tempting to believe that he was the world's greatest photographer. But then you think of Henri Cartier-Bresson, Robert Capa, Ansel Adams and a dozen others, all of whom produced pictures that have an enduring quality. Mr Karsh was, though, for half a century perhaps the greatest portrait photographer in the monumental manner. Unlike Mr Cartier-Bresson, the master of the Leica, Mr Karsh preferred to use a camera that looked hardly different from the weighty apparatus of the Victorian pioneers. It stood on a hefty tripod and the image was captured on a glass negative almost the size of a page of *The Economist*.

Intimidated by this awesome instrument the sitter was expected to be patient as Mr Karsh composed the lighting, a hot light here, a softer one there. The camera is focused, and Mr Karsh emerges from under a dark cloth. The negative holder slides in. The sitter is expectant, and probably restless. It can't be long now. But Mr Karsh is not quite ready. He once said, “Look and think before opening the shutter. The heart and mind are the true lens of the camera. If it is a likeness alone, it's not a success.”

Mr Cartier-Bresson would no doubt concur. Whether the image is falling on 35mm film or on a glass plate, the aim is to capture what Mr Karsh called the “brief moment” of truth. How is it done? No one is sure, not even the photographer. Whatever it is, great photographers have it. The many millions of happy snappers do not.

Mr Karsh's portraits have been faulted, by those reckless enough to criticise him, for all looking the same: impressive, solemn, usually in black and white to heighten the feeling of drama. It is said he could make the woman next door look like Queen Elizabeth. His admirers retort that this was his style. It was like complaining that Rembrandt's paintings did not make you laugh. No one expressed surprise that Karsh and Rembrandt could be mentioned in the same breath.

When fame came

Yousuf Karsh was a Canadian by adoption: Karsh of Ottawa is how he signed his photographs. But he thought of himself as an Armenian. After hundreds of years as an independent state Armenia had been eventually divided between Turkey and Russia. Mr Karsh had the misfortune to be born in the part ruled by Turkey, whose policy toward Armenians was to exterminate them. In his teens he joined the flow of Armenians who found refuge in North America. An uncle in Canada who was doing well as a portrait photographer gave young Yousuf a job and a cheap camera of the time called a Box Brownie (with which he won a prize). A few years later he was taken on by John Garo, a well-known Boston portrait photographer of that era, who also happened to be an Armenian.

In the 1930s Mr Karsh had his own business in Ottawa. His leisure time he spent with a local drama group, experimenting with lighting. What transformed him from a journeyman photographer into a star was a chance opportunity to photograph Winston Churchill, who in December 1941 was on a brief visit to Ottawa. Mr Karsh set up his equipment in a room in the Canadian Parliament. Churchill was led in, grumbling. “Why was I not told of this?” He said Mr Karsh could have two minutes and no more to take his picture and lit a cigar. “Forgive me, sir,” Yousuf Karsh said, removing the cigar from Churchill's lips, and releasing the shutter on his camera.

Looking at the picture now, and knowing the story behind it, you can imagine Churchill, slightly petulant, deprived of his dummy. But at the time the expression matched the widespread feeling about the British leader, pugnaciously leading a brave nation against an all-conquering foe. *Life* magazine bought the picture for $100. Mr Karsh did not haggle. He just wanted to see his work in print. Eventually it became the most reproduced portrait in the history of photography.

Mr Karsh was never again looking for work. The work came looking for him. Over the years practically anyone who was anyone had their picture taken by Yousuf Karsh. “People of consequence”, he called them, politicians, royalty, popes, writers, scientists, actors. To be “Karshed” proved that you had arrived. It was almost like buying immortality. There are Karsh portraits of a succession of 12 United States presidents. Mr Karsh loved the famous. “It's the minority that make the world go around,” he said.

He seemed to be aware that his gift could be misused. It was clever to make a politician look like a statesman, but was this artistically truthful? Mr Karsh confronted this tricky question in an essay in which he considered the difference between photographing the merely famous and “the challenge of portraying true greatness adequately”.

He reckoned that he had met the challenge with Albert Einstein, Ernest Hemingway and Pablo Casals, among others. As a preliminary to a “challenge” he would get to know as much about a subject as possible; read biographies, speak to the subject's friends. But any photographer could do that. Why did Mr Karsh quite often capture, as he said, “the essential element that has made them great”? He did not know how the magic worked. “And I am not going to make inquiries.”

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Overview

Jul 18th 2002
From The Economist print edition

America's top central banker cheered frazzled investors. Alan Greenspan's testimony this week to both houses of Congress may have briefly halted the slide in equity prices. But even as he lamented the "infectious greed" behind America's corporate scandals, infectious fear continued to weigh on most big **stockmarkets**. America's Dow Jones Industrial Average fell by 3.1% over the week. European markets suffered even more: the FTSE Eurotop index of top 300 companies dropped by 5.6%. Britain's FTSE 100 index declined to its lowest level since 1996.

Mr Greenspan declared that **America's** recovery is on track. Indeed he raised the Federal Reserve's forecast of growth this year from 2.5-3.0% to 3.5-3.75%. His remarks suggested that the Fed will continue to stay its hand on interest rates, which are at their lowest for 40 years. The latest figures on industrial production appear to confirm Mr Greenspan's confidence about the recovery. Output rose for a sixth consecutive month, expanding by 0.2% in the year to June. The much-reviled high-tech sector grew by 10.4% over the same period.

The **euro** breached parity against the **dollar** for the first time since February 2000. The dollar's trade-weighted value declined by 0.9% over the week.

Industrial production in the **euro area** fell by 1.2% in the year to May, contracting by 2% in the Netherlands and by 1.5% in Italy. There are growing concerns in Europe that the strengthening euro may hit exports and weaken the economic recovery.

The yen's recent strength against the dollar appears not to be hurting **Japan's** exporters yet. Japan's trade surplus rose to $76.3 billion in the 12 months to May and its year-on-year current-account surplus increased for the eighth consecutive month, reaching $101.3 billion in the same period.

In **Britain**, consumer-price inflation in June fell to just 1%. Excluding mortgage-interest payments, the inflation rate fell to 1.5%, the lowest on record. If it falls below this level, Sir Edward George, governor of the Bank of England, will have to write a letter to the Treasury explaining how the Bank plans to bring inflation back to the target of 2.5% a year. Growth of average earnings rose from 3.3% in the year to April to 3.8% in the year to May. The number of people claiming unemployment benefit rose a little in June, but still remains below a million.

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Output, demand and jobs

Jul 18th 2002
From The Economist print edition

% change on year ago

	GDP		The Economist poll GDP forecasts		Industrial production	Retail sales (volume)	Unemployment % rate	
	1 qtr*	1 year	2002	2003	latest	latest	latest	year ago
Australia	+ 3.6	+ 4.2 Q1	+ 4.0	+ 3.9	+ 4.3 Q1	+ 5.0 Q1	6.5 Jun	6.9
Austria	+ 0.3	– 0.6 Q1	+ 1.2	+ 2.6	+ 3.5 Apr	+ 0.2 Mar	4.1 May	3.5
Belgium	+ 2.0	– 0.3 Q1	+ 1.4	+ 3.1	– 2.5 May	+ 1.8 Apr	10.4 Jun†	9.9
Britain	+ 0.7	+ 1.1 Q1	+ 1.7	+ 3.0	– 1.9 May	+ 5.4 May	5.2 May‡	4.9
Canada	+ 6.0	+ 2.1 Q1	+ 3.2	+ 3.6	+ 1.3 Apr	+ 5.1 Apr	7.5 Jun	7.0
Denmark	+ 1.4	+ 1.1 Q1	+ 1.6	+ 2.4	+ 2.5 May	+ 1.5 Apr	5.1 May	5.2
France	+ 1.4	+ 0.3 Q1	+ 1.4	+ 2.9	+ 0.3 May	+ 2.3 May	9.1 May	8.6
Germany	+ 0.7	– 1.2 Q1	+ 0.9	+ 2.6	– 3.9 May	– 4.6 May	9.8 Jun§	9.3
Italy	+ 0.6	+ 0.1 Q1	+ 1.2	+ 2.8	– 1.5 May	– 1.2 Apr	9.0 Apr	9.5
Japan	+ 5.7	– 1.6 Q1	– 0.4	+ 1.2	– 2.0 May	– 2.2 May	5.4 May	4.9
Netherlands	+ 0.4	+ 0.3 Q1	+ 1.2	+ 2.8	– 2.0 May	+ 3.3 Apr	2.5 Jun**	2.0
Spain	+ 2.1	+ 2.0 Q1	+ 2.2	+ 3.3	– 1.7 May	na	11.4 May††	10.6
Sweden	+ 1.1	+ 1.1 Q1	+ 1.7	+ 2.9	– 0.1 Apr	+ 4.9 May	3.4 May†	3.5
Switzerland	+ 0.7	+ 0.2 Q1	+ 1.1	+ 2.3	– 8.8 Q1	– 2.4 May	2.5 Jun†	1.6
United States	+ 6.1	+ 1.7 Q1	+ 2.8	+ 3.5	+ 0.2 Jun	+ 4.9 May	5.9 Jun	4.6
Euro area	+ 0.9	+ 0.3 Q1	+ 1.2	+ 2.8	– 1.2 May	+ 0.1 Apr	8.3 May††	8.0
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*							
Finland	– 0.6	– 2.0 Q1	na	na	+ 0.2 May	+ 2.0 Mar	11.9 May†	11.3
Greece	na	+ 4.3 Q1	na	na	+ 4.9 Apr	+19.3 Mar	na	na
Iceland	na	+ 3.12001	na	na	+ 3.3 2001	na	2.3 Jun†	1.2
Ireland	na	nil Q4	na	na	+16.5 May	– 0.5 Apr	4.3 Jun	3.7
Luxembourg	na	+ 3.52001	na	na	+ 8.8 Apr	+ 9.9 Feb	2.7 May	2.4
New Zealand	+ 4.3	+ 4.0 Q1	na	na	+ 4.3 Q1	+ 8.2 Q1	5.3 Q1	5.4
Norway	– 1.1	+ 1.0 Q1	na	na	+ 7.9 May	+ 2.7 May	4.1 Q1	3.7
Portugal	+ 1.8	+ 1.0 Q4	na	na	+ 0.8 May	+ 0.5 May	4.4 Q1†	4.2

*% change at an annual rate. †Not seasonally adjusted. ‡Mar-May; claimant count rate 3.2% in May. §EU harmonised rate 8.3%.
**Apr-Jun. ††Revised series.

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Prices and wages

Jul 18th 2002
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2002	2003	latest		year ago	latest		year ago
Australia	+ 2.9	Q1	+ 6.0	+ 2.7	+ 2.6	+ 0.5	Q1	+ 5.2	+ 4.3	Q1	+ 5.6
Austria	+ 1.7	Jun	+ 2.8	+ 1.8	+ 1.7	– 1.7	Jun	+ 2.9	+ 2.4	May	+ 2.7
Belgium	+ 0.9	Jun	+ 2.9	+ 1.9	+ 1.6	+ 2.4	Jun	+ 0.9	+ 2.6	Q2	+ 2.6
Britain	+ 1.0	Jun	+ 1.9	+ 2.1	+ 2.5	nil	Jun	+ 0.4	+ 3.8	May	+ 4.5
Canada	+ 1.0	May	+ 3.9	+ 1.7	+ 2.2	– 2.6	May	+ 2.8	+ 2.8	Apr	+ 1.5
Denmark	+ 2.2	Jun	+ 2.3	+ 2.3	+ 2.1	– 1.2	Jun	+ 3.2	+ 4.0	Q1	+ 3.8
France	+ 1.4	Jun	+ 2.1	+ 1.8	+ 1.5	– 1.5	May	+ 2.8	+ 3.9	Q1	+ 4.3
Germany	+ 0.8	Jun	+ 3.1	+ 1.5	+ 1.4	– 1.5	Jun	+ 3.1	+ 2.1	Apr	+ 1.5
Italy	+ 2.2	Jun	+ 3.0	+ 2.3	+ 2.0	– 0.9	May	+ 2.9	+ 2.3	Apr	+ 2.6
Japan	– 0.9	May	– 0.7	– 1.0	– 0.4	– 1.0	Jun	+ 0.8	– 0.5	May	– 0.1
Netherlands	+ 3.4	Jun	+ 4.5	+ 3.6	+ 2.5	– 0.7	Apr	+ 6.2	+ 3.2	May	+ 4.9
Spain	+ 3.4	Jun	+ 4.2	+ 3.3	+ 2.8	+ 0.6	May	+ 2.7	+ 4.0	Q1	+ 3.4
Sweden	+ 2.0	Jun	+ 2.9	+ 2.4	+ 2.1	– 0.2	May	+ 2.6	+ 2.0	Apr	+ 3.1
Switzerland	+ 0.3	Jun	+ 1.6	+ 0.8	+ 1.2	– 1.7	Jun	+ 0.4	+ 2.5	2001	+ 1.3
United States	+ 1.2	May	+ 3.6	+ 1.7	+ 2.3	– 2.1	Jun	+ 2.6	+ 3.3	Jun	+ 4.1
Euro area	+ 1.7	Jun	+ 3.0	+ 2.2	+ 1.8	– 0.9	May	+ 3.7	+ 3.3	Q1	+ 2.8
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 1.1	Jun	+ 3.1	na	na	– 1.9	Jun	+ 1.9	+ 3.2	Q1	+ 5.1
Greece	+ 3.3	Jun	+ 3.9	na	na	+ 3.1	Apr	+ 5.1	na		na
Iceland	+ 4.1	Jul	+ 7.0	na	na	+ 7.1	Jun	+ 5.9	+ 7.5	May	+ 8.0
Ireland	+ 4.4	Jun	+ 5.3	na	na	+ 0.3	May	+ 3.4	+ 8.9	Q1	+ 7.4
Luxembourg	+ 1.7	Jun	+ 2.9	na	na	– 2.5	Apr	+ 2.6	nil	Apr	+ 8.4
New Zealand	+ 2.8	Q2	+ 3.2	na	na	+ 2.8	Q1	+ 8.0	+ 2.1	Q1	+ 1.8
Norway	+ 0.4	Jun	+ 3.8	na	na	–15.8	Jun	+ 3.5	+ 4.6	Q1	+ 4.4
Portugal	+ 3.4	Jun	+ 4.5	na	na	– 2.0	May	+ 5.5	na		na

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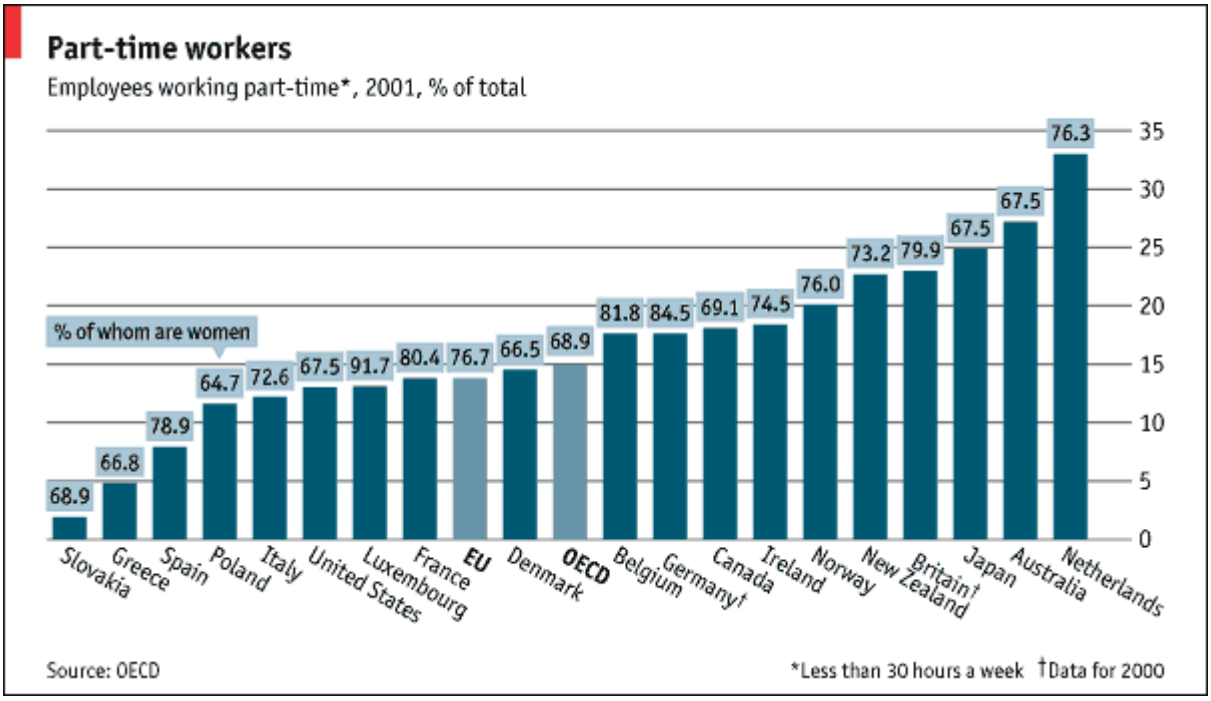
Part-time workers

Jul 18th 2002
From The Economist print edition



The incidence of part-time working varies widely across rich countries. The clear leader is the Netherlands, where part-time employment accounts for 33% of all jobs. By contrast, it represents only 5% of total employment in Greece. Despite these differences, all countries share a common feature: women are the principal part-timers. They account on average for 69% of all part-time workers in OECD countries.

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Money and interest rates

Jul 18th 2002
From The Economist print edition

	Money supply* % change on year ago			Interest rates % p.a. (Jul 17th 2002)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	+ 3.7	+14.9	May	4.99	5.05	5.24	5.95	6.03	7.02‡
Britain	+ 9.1	+ 6.0	May	4.00	5.19	4.37	4.96	5.09	6.04
Canada	+13.6	+ 5.5	May	2.84	4.12	3.59	5.38	5.74	7.09
Denmark	+ 7.4	+ 8.3	May	3.66	4.93	4.35	5.08	5.23	6.91
Japan	+32.1	+ 3.4	Jun	0.03	0.01	0.02	1.26	1.35	1.34
Sweden	+ 2.5	+ 7.3	Apr	4.20	4.30	4.75	5.28	5.35	5.31
Switzerland	+ 8.5	+ 4.3	Jun	1.17	3.23	1.28	3.01	3.38	4.23
United States	+ 5.6	+ 7.2	Jun	1.74	3.59	2.59	4.66	5.09	6.77
Euro area†	+ 7.0	+ 7.8	May	3.41	4.48	3.82	4.82	4.94	6.00

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. ‡New series. Benchmarks: US 30-year 5.45%, Japan No.240 1.27%. Central bank rates: US fed funds 1.75%, ECB refinancing 3.25%, BOJ overnight call 0.001%, BOE repo 4.00%. Sources: Commerzbank, Danske Bank, J.P. Morgan Chase, Royal Bank of Canada, Stockholmsbörsen, UBS Warburg, DRI-WEFA, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

Jul 18th 2002
From The Economist print edition

1995=100

	Jul 2nd‡	Jul 9th‡	Jul 16th*	% change on one month	% change on one year
Dollar index					
All items	72.5	73.2	73.6	+ 5.6	+ 4.6
Food	73.5	74.5	76.1	+10.4	+ 6.7
Industrials					
All	71.2	71.4	70.3	– 0.7	+ 1.6
Nfa†	72.5	73.0	70.6	– 2.6	+ 3.3
Metals	70.1	70.0	69.9	+ 0.9	+ 0.3
Sterling index					
All items	74.7	74.6	73.9	– 0.1	– 6.8
Euro index					
All items	96.7	96.9	95.8	– 0.9	–11.9
Yen index					
All items	92.7	92.0	90.7	– 1.8	– 3.1
Gold					
$ per oz	314.25	313.90	318.00	– 0.3	+18.7
West Texas Intermediate					
$ per barrel	26.83	26.11	27.75	+ 9.5	+ 9.8

* Provisional † Non-food agriculturals ‡Corrected

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Stockmarkets

Jul 18th 2002
From The Economist print edition

Market indices

	Jul 17th	2002 high	2002 low	% change on one week	% change on record high	% change on Dec 31st 2001 in local currency	% change on Dec 31st 2001 in $ terms
Australia (All Ordinaries)	3,072.5	3,440.0	3,072.5	– 3.2	–10.7	– 8.6	– 1.5
Austria (ATX)	1,217.2	1,357.2	1,114.4	– 0.2	–29.9	+ 6.7	+20.8
Belgium (Bel 20)	2,272.4	2,899.8	2,240.9	– 6.7	–38.3	–18.3	– 7.6
Britain (FTSE 100)	4,190.6	5,323.8	3,994.5	– 5.2	–39.5	–19.7	–13.5
Canada (Toronto Composite)	6,699.7	7,958.1	6,677.8	– 3.1	–41.2	–12.9	– 9.7
Denmark (KBX)	195.5	233.4	192.1	– 3.4	–35.2	–13.0	– 1.5
France (SBF 250)	2,324.0	3,081.9	2,251.2	– 5.2	–47.1	–22.0	–11.8
(CAC 40)	3,440.9	4,688.0	3,317.8	– 5.9	–50.3	–25.6	–15.8
Germany (Xetra DAX)	4,092.8	5,462.6	3,912.5	– 2.3	–49.3	–20.7	–10.3
Italy (BCI)	1,185.7	1,513.0	1,156.5	– 5.7	–45.7	–17.3	– 6.4
Japan (Nikkei 225)	10,296.0	11,979.9	9,420.9	– 4.2	–73.5	– 2.3	+10.0
(Topix)	988.1	1,139.4	922.5	– 4.7	–65.7	– 4.3	+ 7.9
Netherlands (AEX)	379.5	531.2	363.9	– 7.4	–45.9	–25.1	–15.3
Spain (Madrid SE)	693.0	848.1	672.5	– 3.4	–39.5	–15.9	– 4.9
Sweden (Affarsvarlden Gen)	167.0	236.8	162.7	– 3.7	–58.3	–27.9	–18.1
Switzerland (Swiss Market)	5,299.7	6,694.1	5,225.3	– 8.2	–37.0	–17.4	– 5.6
United States (DJIA)	8,542.5	10,635.3	8,473.1	– 3.1	–27.1	–14.8	–14.8
(S&P 500)	906.0	1,172.5	900.9	– 1.6	–40.7	–21.1	–21.1
(Nasdaq Comp)	1,397.3	2,059.4	1,346.0	+ 3.8	–72.3	–28.4	–28.4
Europe (FTSE Eurotop 300)*	968.5	1,279.7	936.8	– 5.6	–43.2	–23.2	–13.1
Euro area (FTSE Ebloc 100)*	837.8	1,125.1	808.0	– 5.1	–46.0	–24.7	–14.8
World (MSCI)†	842.8	1,024.4	832.7	– 2.3	–41.8	na	–16.0
World bond market (Salomon)‡	494.1	495.7	430.3	+ 1.4	– 0.3	na	+12.4

*In euro terms. †Morgan Stanley Capital International index includes individual markets listed above plus eight others, in dollar terms.
‡Salomon Smith Barney World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

Jul 18th 2002
From The Economist print edition

	Trade balance*, $bn latest 12 months		Current account $bn latest 12 mths		The Economist poll % of GDP, forecast 2002	2003	Exchange rate trade-weighted† Jul 17th	year ago	Currency units per $ Jul 17th	year ago	per £	per euro	per ¥100	Budget balance % of GDP 2002‡
Australia	+ 0.4	May	− 9.5	Q1	− 3.3	− 3.6	72.3	72.9	1.81	1.94	2.84	1.83	1.56	0.1
Austria	− 2.4	Apr	− 2.5	Apr	− 2.2	− 2.0	101.0	100.0	0.99	1.15	1.55	–	0.85	-0.3
Belgium	+ 13.0	May	+ 13.0	Dec	+ 5.0	+ 5.3	100.4	98.6	0.99	1.15	1.55	–	0.85	nil
Britain	− 45.6	May	− 31.2	Q1	− 2.2	− 2.1	104.8	106.3	0.64	0.71	–	0.64	0.55	-0.8
Canada	+ 35.6	Apr	+ 14.7	Q1	+ 2.2	+ 2.3	76.8	78.6	1.54	1.54	2.41	1.55	1.32	1.0
Denmark	+ 7.1	May	+ 3.5	May	+ 1.9	+ 1.9	103.5	101.7	7.38	8.55	11.6	7.43	6.34	2.2
France	+ 8.5	May	+ 26.2	May	+ 1.8	+ 1.7	103.3	101.1	0.99	1.15	1.55	–	0.85	-2.0
Germany	+ 96.5	May	+ 19.8	May	+ 1.1	+ 1.1	100.5	98.1	0.99	1.15	1.55	–	0.85	-2.8
Italy	+ 8.3	Apr	− 1.4	Apr	+ 0.1	nil	73.7	72.2	0.99	1.15	1.55	–	0.85	-1.4
Japan	+ 76.3	May	+101.3	May	+ 2.7	+ 2.7	137.8	136.9	116	124	182	117	–	-8.0
Netherlands	+ 23.6	May	+ 13.6	Q1	+ 4.0	+ 4.1	99.5	97.4	0.99	1.15	1.55	–	0.85	0.1
Spain	− 36.8	Apr	− 16.6	Apr	− 2.2	− 1.9	75.3	73.9	0.99	1.15	1.55	–	0.85	-0.3
Sweden	+ 14.6	May	+ 8.4	May	+ 3.2	+ 3.3	76.4	75.2	9.24	10.6	14.5	9.31	7.94	2.1
Switzerland	+ 2.3	May	+ 25.7	Q1	+ 9.8	+10.1	114.8	109.0	1.45	1.73	2.28	1.46	1.25	na
United States	−423.2	Apr	−398.1	Q1	− 4.3	− 4.6	111.0	120.3	–	–	1.57	1.01	0.86	-1.0
Euro area	+ 65.5	Apr	+ 16.0	Apr	+ 0.4	+ 0.5	82.6	77.7	0.99	1.15	1.55	–	0.85	-1.5
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*													
Finland	+ 12.1	Apr	+ 7.9	May	na	na	79.5	77.8	0.99	1.15	1.55	–	0.85	3.2
Greece	− 19.1	Dec	− 6.7	Mar	na	na	58.2	57.2	0.99	1.15	1.55	–	0.85	0.4
Iceland	+ 0.1	May	− 0.2	Q1	na	na	na	na	86.1	101	135	86.8	74.0	-0.5
Ireland	+ 33.2	Apr	− 1.1	Q4	na	na	90.0	86.7	0.99	1.15	1.55	–	0.85	0.1
Luxembourg	− 2.9	Apr	+ 0.9	Q4	na	na	100.4	98.6	0.99	1.15	1.55	–	0.85	2.2
New Zealand	+ 0.1	May	− 1.2	Q1	na	na	86.4	79.1	2.08	2.44	3.26	2.10	1.79	0.1
Norway	+ 25.3	Jun	+ 25.9	Apr	na	na	105.7	95.2	7.34	9.19	11.5	7.40	6.31	14.0
Portugal	− 12.9	Apr	− 9.8	Apr	na	na	90.4	89.0	0.99	1.15	1.55	–	0.85	-2.4

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †1990=100, Bank of England. ‡OECD forecast.

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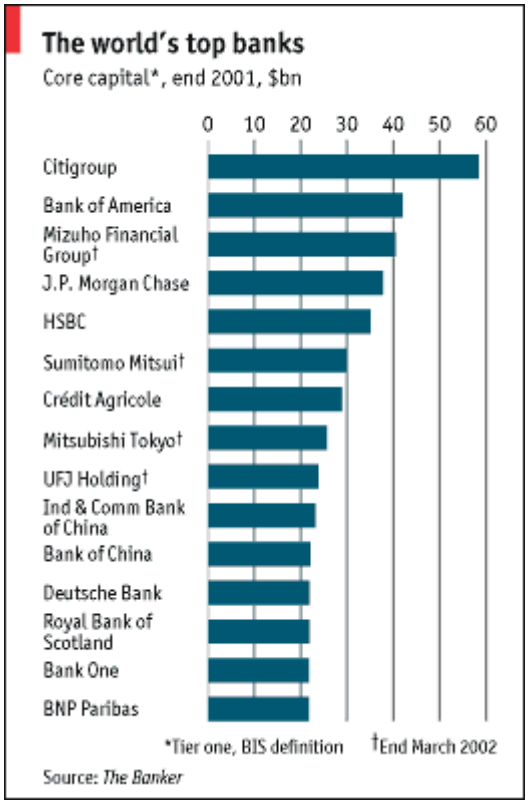
The world's top banks

Jul 18th 2002
From The Economist print edition



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Overview

Jul 18th 2002
From The Economist print edition

China's economy continues to do well, at least on official figures. GDP grew by the usual 8% in the year to the second quarter. Consumer prices fell by 0.8% in the year to June.

Singapore's economic recovery continues to gather strength. GDP grew by 3.2% in the year to the second quarter.

Industrial output in **India** rose by 3.8% in the year to May.

Consumer-price inflation in **South Africa** rose by a faster-than-expected 8.9% in the year to June. In the year to June, inflation rose to 6.6% in **Israel**, from 5.5% in May.

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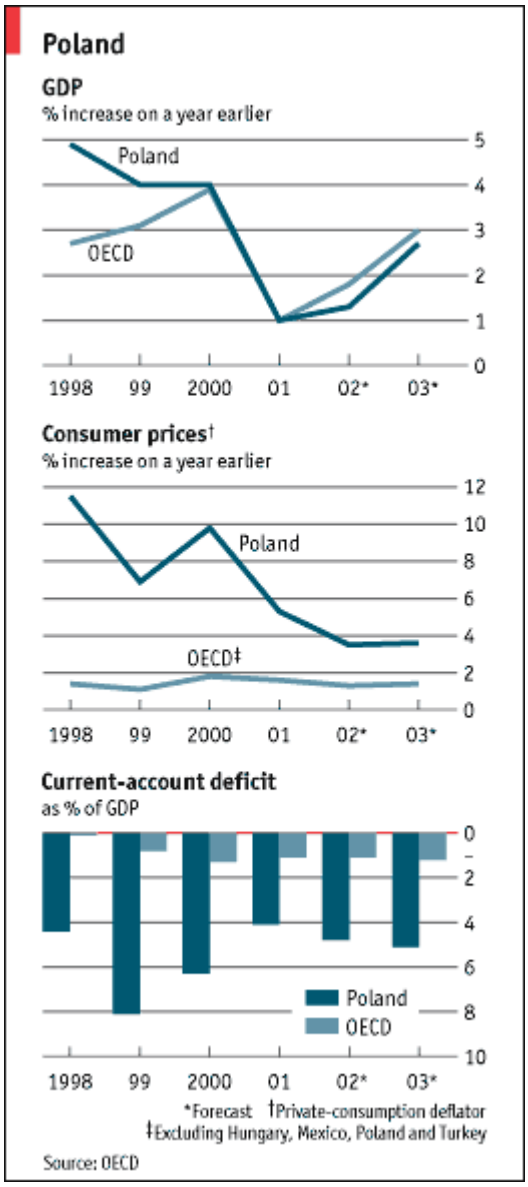
Poland

Jul 18th 2002
From The Economist print edition

After years as one of Europe's fastest-growing countries, Poland's economy slowed substantially last year. A sharp fall in investment dragged GDP growth down from 4% in 2000 to just 1%. Unemployment reached 19% of the workforce. According to the OECD's latest forecast, the economy will recover only sluggishly. The OECD expects GDP to grow by 1.3% this year and by 2.7% in 2003. Inflation will remain low, however.



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Economy

Jul 18th 2002
From The Economist print edition

	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+ 8.0	Q2	+12.4	Jun	– 0.8	Jun	+27.9	Jun	+21.2	2001§	237.2	Apr
Hong Kong	– 0.9	Q1	–11.6	Q1	– 3.1	May	– 8.8	May	+14.5	Q1	112.4	Jun
India	+ 6.4	Q1	+ 3.8	May	+ 4.7	May	– 5.7	May	+ 1.4	Q1	54.7	Jun
Indonesia	+ 2.5	Q1	– 9.4	Q4	+11.5	Jun	+26.9	May	+ 7.3	Q3	27.9	May
Malaysia	+ 1.1	Q1	+ 4.0	May	+ 1.6	May	+13.2	May	+ 7.0	Q1	32.6	May
Philippines	+ 3.8	Q1	+17.0	Apr	+ 3.0	Jun	+ 2.3	Apr	+ 5.2	Mar	14.1	Jun
Singapore	+ 3.2	Q2	+17.0	May	– 0.3	May	+ 6.1	May	+18.4	Q1	80.4	Jun
South Korea	+ 5.7	Q1	+ 7.7	May	+ 2.6	Jun	+ 8.7	Jun	+ 5.9	May	109.6	May
Taiwan	+ 0.9	Q1	+10.1	May	+ 0.1	Jun	+18.6	Jun	+22.0	Q1	148.2	Jun
Thailand	+ 3.9	Q1	+ 8.4	May	+ 0.2	Jun	+ 4.2	May	+ 6.5	May	34.5	May
Argentina	–16.3	Q1	–12.8	Jun	+28.4	Jun	+11.8	May	nil	Q1	10.2	May
Brazil	– 0.7	Q1	– 0.9	May	+ 7.7	Jun	+ 5.3	Jun	–19.0	May	32.9	May
Chile	+ 1.5	Q1	– 3.8	May	+ 2.0	Jun	+ 2.3	Jun	– 1.0	Q1	15.0	May
Colombia	+ 0.5	Q1	+ 7.8	Apr	+ 6.3	Jun	+ 0.6	Mar	– 1.4	Q1	10.5	May
Mexico	– 2.0	Q1	+ 8.0	Apr	+ 4.9	Jun	– 9.2	May	–16.8	Q1	44.9	May
Peru	+ 4.3	May	+ 8.6	Apr	– 0.2	Jun	– 0.1	Apr	– 1.0	Q1	8.7	May
Venezuela	– 4.2	Q1	–20.0	Mar	+19.6	Jun	+ 8.0	Q1	+ 1.8	Q1	6.7	Apr
Egypt	+ 4.9	2001†	+ 7.8	2001†	+ 2.7	Apr	– 8.4	Mar	– 0.1	Q1	12.6	Mar
Israel	– 4.2	Q1	– 3.5	Apr	+ 6.6	Jun	– 6.4	Jun	– 2.3	Q1	24.8	Jun
South Africa	+ 2.1	Q1	+ 6.8	May	+ 8.9	Jun	+ 3.8	May	– 0.1	Q1	5.9	May
Turkey	+ 2.3	Q1	+11.0	May	+42.6	Jun	– 8.9	Apr	+ 2.6	Apr	22.0	May
Czech Republic	+ 2.5	Q1	+ 5.1	May	+ 1.2	Jun	– 2.5	May	– 2.4	Q1	21.2	Jun
Hungary	+ 2.9	Q1	– 0.7	May	+ 4.8	Jun	– 2.4	May	– 1.8	May	10.2	Jun
Poland	+ 0.5	Q1	+ 2.2	Jun	+ 1.6	Jun	–10.8	May	– 7.1	May	28.2	Jun
Russia	+ 3.7	Q1	+ 4.4	Jun	+14.9	Jun	+43.4	May	+31.2	Q1	39.8	Jun
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Pakistan	+ 3.3	2001†	–10.1	Feb	+ 2.9	May	– 1.1	May	+ 0.3	2001†	4.1	May
Saudi Arabia	+ 1.2	2001	na		nil	Mar	+44.1	2001	+14.5	2001	18.4	May

*Excluding gold, except Singapore; IMF definition. †Year ending June. §Economist Intelligence Unit estimate.

Text refers only to the first 25 countries listed

Sources: National statistics offices, central banks and stock exchanges; Thomson Financial Datastream; Economist Intelligence Unit; Reuters; Warburg Dillon Read; J.P Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Garanti Bank; Deutsche Bank; *Russian Economic Trends*.

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Financial markets

Jul 18th 2002
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	Jul 17th		Dec 31st 2001	
	Jul 17th	year ago	Jul 17th	% p.a.		one week	in local currency	in $ terms
China	8.28	8.28	13.0	na	1,775.6	nil	+ 3.7	+ 3.7
Hong Kong	7.80	7.80	12.2	1.81	10,335.1	– 4.2	– 9.3	– 9.3
India	48.8	47.2	76.4	5.72	3,216.1	– 3.5	– 1.4	– 2.5
Indonesia	8,965	11,275	14,045	15.64	479.4	+ 0.4	+ 22.3	+ 41.9
Malaysia	3.80	3.80	5.95	3.25	731.2	– 1.6	+ 5.0	+ 5.0
Philippines	50.4	54.3	78.9	6.56	1,157.3	+ 0.4	– 0.9	+ 1.5
Singapore	1.74	1.83	2.72	0.75	1,583.3	– 3.0	– 2.5	+ 3.5
South Korea	1,162	1,307	1,820	4.95	771.5§	– 2.9	+ 11.2	+ 25.7
Taiwan	32.8	35.0	51.4	2.10	5,250.8	– 0.2	– 5.4	+ 0.9
Thailand	40.5	45.8	63.5	2.06	394.3	– 2.1	+ 29.8	+ 41.6
Argentina	3.50	1.00	5.48	45.00	375.3	– 2.5	+ 27.1	– 63.7
Brazil	2.89	2.46	4.52	18.40	10,754.6	+ 1.9	– 20.8	– 36.6
Chile	693	655	1,086	3.48	4,743.2	– 2.2	– 12.1	– 16.2
Colombia	2,528	2,298	3,960	8.16	1,217.6	– 0.7	+ 13.7	+ 2.4
Mexico	9.63	9.13	15.1	7.24	6,403.3	+ 0.5	+ 0.5	– 4.4
Peru	3.54	3.50	5.54	3.14	1,169.7	+ 3.5	– 0.5	– 3.1
Venezuela	1,316	724	2,061	33.96	7,181.9	– 0.3	+ 9.3	– 37.1
Egypt	4.63	3.95	7.26	7.19	5,575.4	+ 5.5	+ 5.7	+ 4.4
Israel	4.66	4.21	7.30	6.40	370.1	+ 2.3	– 17.2	– 21.5
South Africa	10.1	8.21	15.9	12.05	10,284.4	– 0.3	– 1.5	+ 16.4
Turkey	1,641,750	1,369,500	2,571,966	44.00	10,523.7	+18.0	– 23.6	– 32.3
Czech Republic	29.5	38.9	46.2	3.38	428.5	– 1.3	+ 8.6	+ 30.8
Hungary	244	285	382	9.65	7,459.2	– 1.7	+ 4.6	+ 17.8
Poland	4.09	4.21	6.41	8.88	13,916.1	– 0.5	nil	– 3.5
Russia	31.6	29.3	49.5	23.00	376.6‡	– 3.7	+ 49.9	+ 44.8
EMF (MSCI)*	1.00	1.00	1.57	na	324.7	– 0.9	na	+ 2.3
EMBI+†	1.00	1.00	1.57	na	203.7	+ 0.9	na	+ 1.7

*Emerging Mkts Free. †J.P. Morgan Chase's Emerging Mkts Bond Index Plus. ‡ In $ terms. § Jul 16th.

Sources: National statistics offices, central banks and stock exchanges; Thomson Financial Datastream; Economist Intelligence Unit; Reuters; Warburg Dillon Read; J.P Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Garanti Bank; Deutsche Bank; *Russian Economic Trends.*

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